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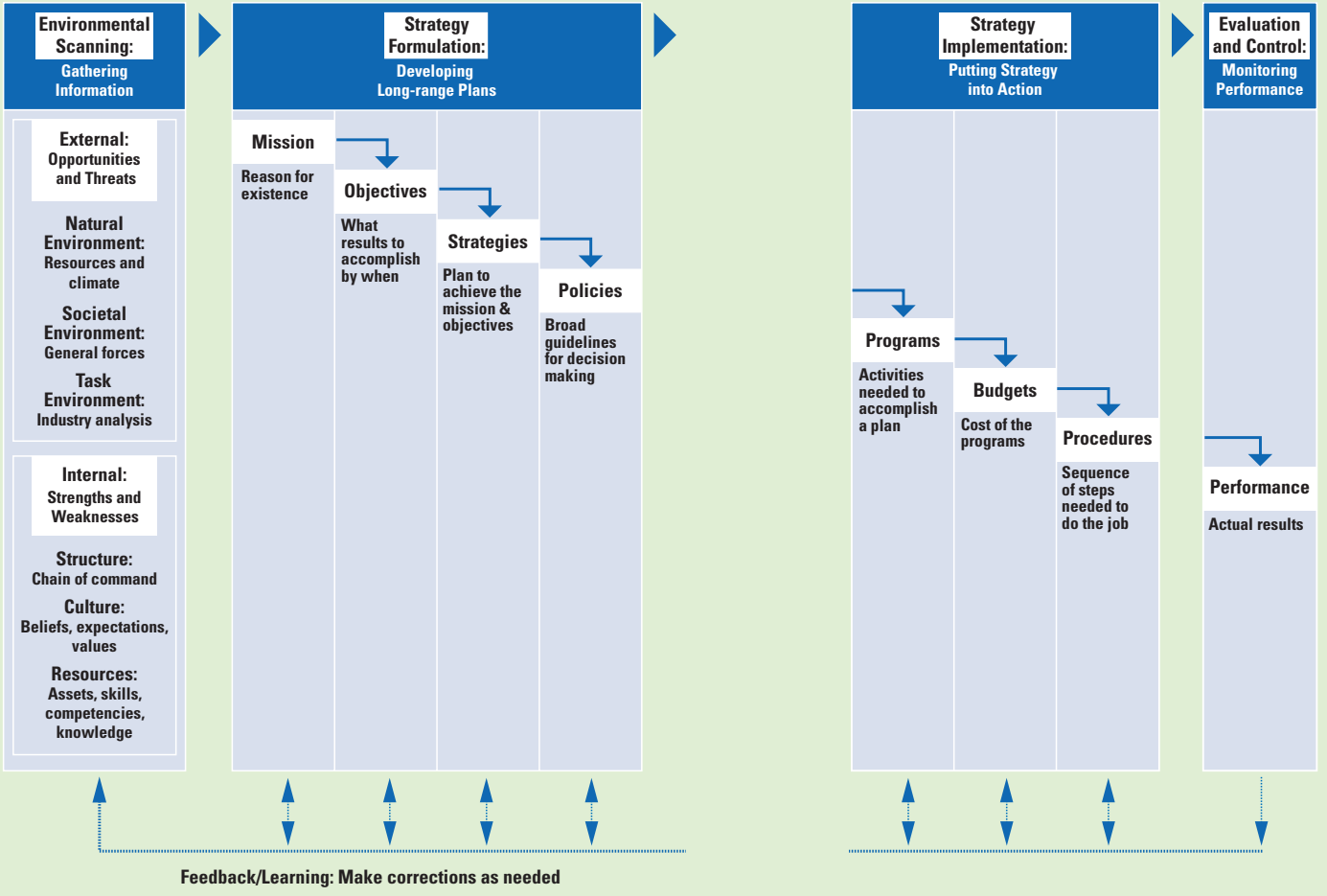
STRATEGIC MANAGEMENT AND Business Policy

TOWARD GLOBAL SUSTAINABILITY

THOMAS L. WHEELEN • J. DAVID HUNGER

Strategic Management Model



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Dedicated to

KATHY, RICHARD, AND TOM

BETTY, KARI AND JEFF, MADDIE AND MEGAN, SUZI AND NICK, SUMMER AND KACEY, LORI, MERRY AND DYLAN, AND WOOFIE (ARF!).

SPECIAL DEDICATION TO KATHRYN WHEELEN:

Kathryn has worked on every phase of the case section of this book. Until this edition, she also managed the construction of the Case Instructor's Manual. *She has done every job with a high level of dedication and concern for both the case authors and the readers of this book.*

This book is also dedicated to the following Prentice Hall/Pearson sales representatives who work so hard to promote this book:

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CASE 1 The Recalcitrant Director at Byte Products Inc.: Corporate Legality versus Corporate Responsibility 1-7
(Contributors: Dan R. Dalton, Richard A. Cosier, and Cathy A. Enz)
A plant location decision forces a confrontation between the board of directors and the CEO regarding an issue in social responsibility and ethics.

CASE 2 The Wallace Group 2-1
(Contributor: Laurence J. Stybel)
Managers question the company's strategic direction and how it is being managed by its founder and CEO. Company growth has resulted not only in disorganization and confusion among employees, but in poor overall performance. How should the board deal with the company's founder?

SECTION B Business Ethics

CASE 3 Everyone Does It 3-1
(Contributors: Steven M. Cox and Shawana P. Johnson)
When Jim Willis, Marketing VP, learns that the launch date for the company's new satellite will be late by at least a year, he is told by the company's president to continue using the earlier published date for the launch. When Jim protests that the use of an incorrect date to market contracts is unethical, he is told that spacecraft are never launched on time and that it is common industry practice to list unrealistic launch dates. If a realistic date was used, no one would contract with the company.

CASE 4 The Audit 4-1

(Contributors: John A. Kilpatrick, Gamewell D. Gantt, and George A. Johnson)

A questionable accounting practice by the company being audited puts a new CPA in a difficult position. Although the practice is clearly wrong, she is being pressured by her manager to ignore it because it is common in the industry.

SECTION C International Issues in Strategic Management

CASE 5 Starbucks' Coffee Company: The Indian Dilemma 5-1

(Contributors: Ruchi Mankad and Joel Sarosh Thadamalla)

Starbucks is the world's largest coffee retailer with over 11,000 stores in 36 countries and over 10,000 employees. The case focuses on India as a potential market for the coffee retailer, presenting information on India's societal environment and beverage industry. Profiles are provided for various existing coffee shop chains in India. The key issue in the case revolves around the question: Are circumstances right for Starbucks to enter India?

CASE 6 Guajilote Cooperativo Forestal: Honduras 6-1

(Contributors: Nathan Nebbe and J. David Hunger)

exclusive

This forestry cooperative has the right to harvest, transport, and sell fallen mahogany trees in La Muralla National Park of Honduras. Although the cooperative has been successful thus far, it is facing some serious issues: low prices for its product, illegal logging, deforestation by poor farmers, and possible world trade restrictions on the sale of mahogany.

SECTION D General Issues in Strategic Management

INDUSTRY ONE: Information Technology

CASE 7 Apple Inc.: Performance in a Zero-Sum World Economy 7-1

(Contributors: Kathryn E. Wheelen, Thomas L. Wheelen II, Richard D. Wheelen, Moustafa H. Abdelsamad, Bernard A. Morin, Lawrence C. Pettit, David B. Croll, and Thomas L. Wheelen)

new exclusive

Apple, the first company to mass-market a personal computer, had become a minor player in an industry dominated by Microsoft. After being expelled from the company in 1985, founder Steve Jobs returned as CEO in 1997 to reenergize the firm. The introduction of the iPod in 2001, followed by the iPad, catapulted Apple back into the spotlight. However, in 2011 Jobs was forced to take his third medical leave, leading to questions regarding his ability to lead Apple. How can Apple continue its success? How dependent is the company on Steve Jobs?

CASE 8 iRobot: Finding the Right Market Mix? 8-1

(Contributor: Alan N. Hoffman)

new exclusive

Founded in 1990, iRobot was among the first companies to introduce robotic technology into the consumer market. Employing over 500 robotic professionals, the firm planned to lead the robotics industry. Unfortunately, its largest revenue source, home care robots, are a luxury good and vulnerable to recessions. Many of iRobot's patents are due to expire by 2019. The firm is highly dependent upon suppliers to make its consumer products and the U.S. government for military sales. What is the best strategy for its future success?

CASE 9 Dell Inc.: Changing the Business Model (Mini Case) 9-1

(Contributor: J. David Hunger)

new exclusive

Dell, once the largest PC vendor in the world, is now battling with Acer for second place in the global PC market. Its chief advantages—direct marketing and power over suppliers—no longer provided a competitive advantage. The industry's focus has shifted from desktop PCs to mobile computing, software, and technology services, areas of relative weakness for Dell. Is it time for Dell to change its strategy?

CASE 10 Rosetta Stone Inc.: Changing the Way People Learn Languages 10-1
(Contributors: Christine B. Buenafe and Joyce P. Vincelette)

new exclusive

Rosetta Stone's mission was to change the way people learn languages. The company blended language learning with technology at a time when globalization connected more and more individuals and institutions to each other. How should the company move forward? Would it be appropriate for Rosetta Stone to offer products like audio books or services in order to increase market share? Which international markets could provide the company with a successful future?

CASE 11 Logitech (Mini Case) 11-1
(Contributor: Alan N. Hoffman)

new exclusive

Logitech, the world's leading provider of computer peripherals, was on the forefront of mouse, keyboard, and video conferencing technology. By 2010, however, Logitech's products were threatened by new technologies, such as touch pads, that could replace both the mouse and keyboard. As the peripherals market begins to disintegrate, Logitech is considering a change in strategy.

INDUSTRY TWO: INTERNET COMPANIES

CASE 12 Google Inc. (2010): The Future of the Internet Search Engine 12-1
(Contributor: Patricia A. Ryan)

new exclusive

Google, an online company that provides a reliable Internet search engine, was founded in 1998 and soon replaced Yahoo as the market leader in Internet search engines. By 2010, Google was one of the strongest brands in the world. Nevertheless, its growth by acquisition strategy was showing signs of weakness. Its 2006 acquisition of YouTube had thus far not generated significant revenue growth. Groupon, a shopping Web site, rebuffed Google's acquisition attempt in 2010. Is it time for a strategic change?

CASE 13 Reorganizing Yahoo! 13-1
(Contributors: P. Indu and Vivek Gupta)

Yahoo! created the first successful Internet search engine, but by 2004 it was losing its identity. Was it a search engine, a portal, or a media company? On December 5, 2006, Yahoo's CEO announced a reorganization of the company into three groups. It was hoped that a new mission statement and a new structure would make Yahoo leaner and more responsive to customers. Would this be enough to turn around the company?

INDUSTRY THREE: ENTERTAINMENT AND LEISURE

CASE 14 TiVo Inc.: TiVo vs. Cable and Satellite DVR: Can TiVo survive? 14-1
(Contributors: Alan N. Hoffman, Randy Halim, Rangki Son, and Suzanne Wong)

TiVo was founded to create a device capable of recording digitized video on a computer hard drive for television viewing. Even though revenues had jumped from $96 million in 2003 to $259 million in 2007, the company had never earned a profit. Despite many alliances, TiVo faced increasing competition from generic DVRs offered by satellite and cable companies. How long can the company continue to sell TiVo DVRs when the competition sells generic DVRs at a lower price or gives them away for free?

CASE 15 Marvel Entertainment Inc. 15-1
(Contributors: Ellie A. Fogarty and Joyce P. Vincelette)

exclusive

Marvel Entertainment was known for its comic book characters Captain America, Spider Man, the Fantastic Four, the Incredible Hulk, the Avengers, and the X-Men. With its 2008 self-produced films, Iron Man *and* The Incredible Hulk, *Marvel had expanded out of comic books to become a leader in the entertainment industry. The company was no longer competing against other comic book publishers like DC Comics, but was now competing against entertainment giants like Walt Disney and NBC Universal. What should Marvel's management do to ensure the company's future success?*

CASE 16 Carnival Corporation and plc (2010) 16-1

(Contributors: Michael J. Keeffe, John K. Ross III, Sherry K. Ross, Bill J. Middlebrook, and Thomas L. Wheelen)

new exclusive

With its "fun ship," Carnival Cruises changed the way people think of ocean cruises. The cruise became more important than the destination. Through acquisition, Carnival expanded its product line to encompass an entire range of industry offerings. How can Carnival continue to grow in the industry it now dominates?

INDUSTRY FOUR: TRANSPORTATION

CASE 17 Chrysler in Trouble 17-1

(Contributors: Barnali Chakraborty and Vivek Gupta)

new

On April 30, 2009, Chrysler Motors, the third-largest auto manufacturer in the United States, filed for bankruptcy protection along with its 24 wholly owned U.S. subsidiaries. As a condition of the U.S. federal government's loan of more than $8 billion, Fiat was given 20% of the new Chrysler Corporation with the option of increasing its stake to 51% by 2016 after the new company had repaid the federal government's loan. What does Chrysler need to do to ensure the success of its partnership with Fiat?

CASE 18 Tesla Motors Inc. (Mini Case) 18-1

(Contributor: J. David Hunger)

new exclusive

Tesla Motors was founded in 2004 to produce electric automobiles. Its first car, the Tesla Roadster, sold for $101,000. It could accelerate from zero to 60 mph in 3.9 seconds and cruise for 236 miles on a single charge. In contrast to existing automakers, Tesla sold and serviced its cars through the Internet and its own Tesla stores. With the goal of building a full line of electric vehicles, Tesla Motors faced increasing competition from established automakers. How could Tesla Motors succeed in an industry dominated by giant global competitors?

CASE 19 Harley-Davidson Inc. 2008: Thriving through a Recession 19-1

(Contributors: Patricia A. Ryan and Thomas Wheelen)

exclusive

Harley-Davidson 2008: Thriving Through Recession is a modern success story of a motorcycle company that turned itself around by emphasizing quality manufacturing and image marketing. After consistently growing through the 1990s, sales were showing signs of slowing as the baby boomers continued to age. Safety was also becoming an issue. For the first time in recent history, sales and profits declined in 2007 from 2006. Analysts wondered how the company would be affected in a recession. How does Harley-Davidson continue to grow at its past rate?

CASE 20 JetBlue Airways: Growing Pains? 20-1

(Contributors: Shirisha Regani and S. S. George)

JetBlue Airways had been founded as a "value player" in the niche between full service airlines and low-cost carriers. Competition had recently intensified and several airlines were taking advantage of bankruptcy protection to recapture market share through price cuts. JetBlue's operating costs were rising as a result of increasing fuel costs, aircraft maintenance expenses, and service costs. Has JetBlue been growing too fast and was growth no longer sustainable?

CASE 21 TomTom: New Competition Everywhere! 21-1

(Contributor: Alan N. Hoffman)

new exclusive

TomTom, an Amsterdam-based company that provided navigation services and devices, led the navigation systems market in Europe and was second in popularity in the United States. However, the company was facing increasing competition from other platforms using GPS technology like cell phones and Smartphones with a built-in navigation function. As its primary markets in the United States and Europe mature, how can the company ensure its future growth and success?

INDUSTRY FIVE: CLOTHING

CASE 22 Volcom Inc.: Riding the Wave 22-1

(Contributors: Christine B. Buenafe and Joyce P. Vincelette)

new exclusive

Volcom was formed south of Los Angeles in 1991 as a clothing company rooted in the action sports of skateboarding, surfing, and snowboarding. By 2008, Volcom-branded products were sold throughout the United States and in over 40 countries. It did not own any manufacturing facilities, but instead worked with foreign contract manufacturers. As a primary competitor in the boardsports community, Volcom was committed to maintaining its brand, position, and lifestyle and needed to reassess its strategy.

CASE 23 TOMS Shoes (Mini Case) 23-1

(Contributor: J. David Hunger)

new exclusive

Founded in 2006 by Blake Mycoskie, TOMS Shoes is an American footwear company based in Santa Monica, California. Although TOMS Shoes is a for-profit business, its mission is more like that of a not-for-profit organization. The firm's reason for existence is to donate to children in need one new pair of shoes for every pair of shoes sold. By 2010, the company had sold over one million pairs of shoes. How should the company plan its future growth?

INDUSTRY SIX: SPECIALTY RETAILING

CASE 24 Best Buy Co. Inc.: Sustainable Customer Centricity Model? 24-1

(Contributor: Alan N. Hoffman)

new exclusive

Best Buy, the largest consumer electronics retailer in the United States, operates 4,000 stores in North America, China, and Turkey. Best Buy distinguishes itself from competitors by deploying a differentiation strategy based on superior service rather than low price. The recent recession has stressed its finances and the quality of its customer service. How can Best Buy continue to have innovative products, top-notch employees, and superior customer service while facing increased competition, operational costs, and financial stress?

CASE 25 The Future of Gap Inc. 25-1

(Contributor: Mridu Verma)

Gap Inc. offered clothing, accessories, and personal care products under the Gap, Banana Republic, and Old Navy brands. After a new CEO introduced a turnaround strategy, sales increased briefly, then fell. Tired of declining sales, the board of directors hired Goldman Sachs to explore strategies to improve, ranging from the sale of its stores to spinning off a single division.

CASE 26 Rocky Mountain Chocolate Factory Inc. (2008) 26-1

(Contributors: Annie Phan and Joyce P. Vincelette)

exclusive

Rocky Mountain Chocolate Factory had five company-owned and 329 franchised stores in 38 states, Canada, and the United Arab Emirates. Even though revenues and net income had increased from 2005 through 2008, they had been increasing at a decreasing rate. Candy purchased from the factory by the stores had actually dropped 9% in 2008 from 2007. Was the bloom off the rose at Rocky Mountain Chocolate?

CASE 27 Dollar General Corporation (Mini Case) 27-1

(Contributor: Kathryn E. Wheelen)

new exclusive

With annual revenues of $12.7 billion and 9,200 stores in 35 states, Dollar General is the largest of the discount "dollar stores" in the United States. Although far smaller than its "big brothers" Wal-Mart and Target, Dollar General has done very well during the recent economic recession. In 2011, it plans to open 625 new stores in three new states. Given that the company has substantial long-term debt, is this the right time to expand the company's operations?

INDUSTRY SEVEN: MANUFACTURING

CASE 28 Inner-City Paint Corporation (Revised) 28-1

(Contributors: Donald F. Kuratko and Norman J. Gierlasinski)

Inner-City Paint makes paint for sale to contractors in the Chicago area. However, the founder's lack of management knowledge is creating difficulties for the firm, and the company is in financial difficulty. Unless something is done soon, it may go out of business.

CASE 29 The Carey Plant 29-1

(Contributors: Thomas L. Wheelen and J. David Hunger)

exclusive

The Carey Plant was a profitable manufacturer of quality machine parts until it was acquired by the Gardner Company. Since its acquisition, the plant has been plagued by labor problems, increasing costs, leveling sales, and decreasing profits. Gardner Company's top management is attempting to improve the plant's performance and better integrate its activities with those of the corporation by selecting a new person to manage the plant.

INDUSTRY EIGHT: FOOD AND BEVERAGE

CASE 30 The Boston Beer Company: Brewers of Samuel Adams Boston Lager (Mini Case) 30-1

(Contributor: Alan N. Hoffman)

new exclusive

The Boston Beer Company was founded in 1984 by Jim Koch, viewed as the pioneer of the American craft beer revolution. Brewing over 1 million barrels of 25 different styles of beer, Boston Beer is the sixth-largest brewer in the United States. Even though overall domestic beer sales declined 1.2% in 2010, sales of craft beer have increased 20% since 2002, with Boston Beer's increasing 22% from 2007 to 2009. How can the company continue its rapid growth in a mature industry?

CASE 31 Wal-Mart and Vlasic Pickles 31-1

(Contributor: Karen A. Berger)

A manager of Vlasic Foods International closed a deal with Wal-Mart that resulted in selling more pickles than Vlasic had ever sold to any one account. The expected profit of one to two cents per jar was not sustainable, however, due to unplanned expenses. Vlasic's net income plummeted and the company faced bankruptcy. Given that Wal-Mart was Vlasic's largest customer, what action should management take?

CASE 32 Panera Bread Company (2010): Still Rising Fortunes? 32-1

(Contributors: Joyce Vincelette and Ellie A. Fogarty)

new exclusive

Panera Bread is a successful bakery-café known for its quality soups and sandwiches. Even though Panera's revenues and net earnings have been rising rapidly, new unit expansion throughout North America has fueled this growth. Will revenue growth stop once expansion slows? The retirement of CEO Ronald Shaich, the master baker who created the "starter" for the company's phenomenal growth, is an opportunity to rethink Panera's growth strategy.

CASE 33 Whole Foods Market (2010): How to Grow in an Increasingly Competitive Market? (Mini Case) 33-1

(Contributors: Patricia Harasta and Alan N. Hoffman)

new exclusive

Whole Foods Market is the world's leading retailer of natural and organic foods. The company differentiates itself from competitors by focusing on innovation, quality, and service excellence, allowing it to charge premium prices. Although the company dominates the natural/organic foods category in North America, it is facing increasing competition from larger food retailers, such as Wal-Mart, who are adding natural/organic foods to their offerings.

CASE 34 Burger King (Mini Case) 34-1

(Contributor: J. David Hunger)

new exclusive

Founded in Florida in 1953, Burger King has always trailed behind McDonald's as the second-largest fast-food hamburger chain in the world. Although its total revenues dropped only slightly from 2009, its 2010 profits dropped significantly, due to high expenses. Burger King's purchase by an investment group in 2010 was an opportunity to rethink the firm's strategy.

CASE 35 Church & Dwight: Time to Rethink the Portfolio? 35-1

(Contributor: Roy A. Cook)

new

Church & Dwight, the maker of ARM & HAMMER Baking Soda, has used brand extension to successfully market multiple consumer products based on sodium bicarbonate. Searching for a new growth strategy, the firm turned to acquisitions. Can management successfully achieve a balancing act based on finding growth through expanded uses of sodium bicarbonate while assimilating a divergent group of consumer products into an expanding international footprint?

SECTION E Web Mini Cases

Additional Mini Cases Available on the Companion Web Site at *www.pearsonhighered.com/wheelen.*

WEB CASE 1 Eli Lily & Company

(Contributor: Maryanne M. Rouse)

A leading pharmaceutical company, Eli Lilly produces a wide variety of ethical drugs and animal health products. Despite an array of new products, the company's profits declined after the firm lost patent protection for Prozac. In addition, the FDA found quality problems at several of the company's manufacturing sites, resulting in a delay of new product approvals. How should Lily position itself in a very complex industry?

WEB CASE 2 Tech Data Corporation

(Contributor: Maryanne M. Rouse)

Tech Data, a distributor of information technology and logistics management, has rapidly grown through acquisition to become the second-largest global IT distributor. Sales and profits have been declining, however, since 2001. As computers become more like a commodity, the increasing emphasis on direct distribution by manufacturers threaten wholesale distributors like Tech Data.

WEB CASE 3 Stryker Corporation

(Contributor: Maryanne M. Rouse)

Stryker is a leading maker of specialty medical and surgical products, a market expected to show strong sales growth. Stryker markets its products directly to hospitals and physicians in the United States and 100 other countries. Given the decline in the number of hospitals due to consolidation and cost containment efforts by government programs and health care insurers, the industry expects continued downward pressure on prices. How can Stryker effectively deal with these developments?

WEB CASE 4 Sykes Enterprises

(Contributor: Maryanne M. Rouse)

Sykes provides outsourced customer relationship management services worldwide in a highly competitive, fragmented industry. Like its customers, Sykes has recently been closing its call centers in America and moving to Asia in order to reduce costs. Small towns felt betrayed by the firm's decision to leave—especially after providing financial incentives to attract the firm. Nevertheless, declining revenue and net income has caused the company's stock to drop to an all-time low.

WEB CASE 5 Pfizer Inc.

(Contributor: Maryanne M. Rouse)

With its acquisition in 2000 of rival pharmaceutical firm Warner-Lambert for its Lipitor prescription drug, Pfizer has become the world's largest ethical pharmaceutical company in terms of sales. Already the leading company in the United States, Pfizer's purchase of Pharmacia in 2002 moved Pfizer from fourth to first place in Europe. Will large size hurt or help the company's future growth and profitability in an industry facing increasing scrutiny?

WEB CASE 6 Williams-Sonoma

(Contributor: Maryanne M. Rouse)

Williams-Sonoma is a specialty retailer of home products. Following a related diversification growth strategy, the company operates 415 Williams-Sonoma, Pottery Barn, and Hold Everything retail stores throughout North America. Its direct sales segment includes six retail catalogues and three e-commerce sites. The company must deal with increasing competition in this fragmented industry characterized by low entry barriers.

WEB CASE 7 Tyson Foods Inc.

(Contributor: Maryanne M. Rouse)

Tyson produces and distributes beef, chicken, and pork products in the United States. It acquired IBP, a major competitor, but has been the subject of lawsuits by its employees and the EPA. How should management deal with its poor public relations and position the company to gain and sustain competitive advantage in an industry characterized by increasing consolidation and intense competition?

WEB CASE 8 Southwest Airlines Company

(Contributor: Maryanne M. Rouse)

The fourth-largest U.S. airline in terms of passengers carried and second-largest in scheduled domestic departures, Southwest was the only domestic airline to remain profitable in 2001. Emphasizing high-frequency, short-haul, point-to-point, and low-fare service, the airline has the lowest cost per available seat mile flown of any U.S. major passenger carrier. Can Southwest continue to be successful as competitors increasingly imitate its competitive strategy?

WEB CASE 9 Outback Steakhouse Inc.

(Contributor: Maryanne M. Rouse)

With 1,185 restaurants in 50 states and 21 foreign countries, Outback (OSI) is one of the largest casual dining restaurant companies in the world. In addition to Outback Steakhouse, the company is composed of Carrabba's Italian Grill, Fleming's Prime Steakhouse & Wine Bar, Bonefish Grill, Roy's, Lee Roy Selmon's, Cheeseburger in Paradise, and Paul Lee's Kitchen. Analysts wonder how long OSI can continue to grow by adding new types of restaurants to its portfolio.

WEB CASE 10 Intel Corporation

(Contributor: J. David Hunger)

Although more than 80% of the world's personal computers and servers use its microprocessors, Intel is facing strong competition from AMD in a maturing market. Sales growth is slowing. Profits are expected to rise only 5% in 2006 compared to 40% annual growth previously. The new CEO decides to reinvent Intel to avoid a fate of eventual decline.

WEB CASE 11 AirTran Holdings Inc.

(Contributor: Maryanne M. Rouse)

AirTran (known as ValuJet before a disastrous crash in the Everglades) is the second-largest low-fare scheduled airline (after Southwest) in the United States in terms of departures and, along with Southwest, the only U.S. airline to post a profit in 2004. The company's labor costs as a percentage of sales are the lowest in the industry. Will AirTran continue to be successful in this highly competitive industry?

WEB CASE 12 Boise Cascade/Office Max

(Contributor: Maryanne M. Rouse)

Boise Cascade, an integrated manufacturer and distributor of paper, packaging, and wood products, purchased OfficeMax, the third-largest office supplies catalogue retailer (after Staples and Office Depot), in 2003. Soon thereafter, Boise announced that it was selling its land, plants, headquarters location, and even its name to an equity investment firm. Upon completion of the sale in 2004, the company assumed the name of OfficeMax. Can this manufacturer become a successful retailer?

WEB CASE 13 H. J. Heinz Company

(Contributor: Maryanne M. Rouse)

Heinz, a manufacturer and marketer of processed food products, pursued global growth via market penetration and acquisitions. Unfortunately, its modest sales growth was primarily from its acquisitions. Now that the firm has divested a number of lines of businesses and brands to Del Monte Foods, analysts wonder how a 20% smaller Heinz will grow its sales and profits in this very competitive industry.

WEB CASE 14 Nike Inc.

(Contributor: Maryanne M. Rouse)

Nike is the largest maker of athletic footwear and apparel in the world with a U.S. market share exceeding 40%. Since almost all its products are manufactured by 700 independent contractors (99% of which are in Southeast Asia), Nike is a target of activists opposing manufacturing practices in developing nations. Although industry sales growth in athletic footwear is slowing, Nike refused to change its product mix in 2002 to suit Foot Locker, the dominant global footwear retailer. Is it time for Nike to change its strategy and practices?

WEB CASE 15 Six Flags Inc.: The 2006 Business Turnaround

(Contributor: Patricia A. Ryan)

Known for its fast roller coasters and adventure rides, Six Flags has successfully built a group of regional theme and water parks in the United States. Nevertheless, the company has not turned a profit since 1998. Long-term debt had increased to 61% of total assets by 2005. New management is implementing a retrenchment strategy, but industry analysts are unsure if this will be enough to save the company.

WEB CASE 16 Lowe's Companies Inc.

(Contributor: Maryanne M. Rouse)

As the second-largest U.S. "big box" home improvement retailer (behind Home Depot), Lowe's competes in a highly fragmented industry. The company has grown with the increase in home ownership and has no plans to expand internationally. With more than 1,000 stores in 2004, Lowe's intended to increase its U.S. presence with 150 store openings per year in 2005 and 2006. Are there limits to Lowe's current growth strategy?

WEB CASE 17 Movie Gallery Inc.

(Contributor: J. David Hunger)

Movie Gallery is the second-largest North American video retail rental company, specializing in the rental and sale of movies and video games through its Movie Gallery and Hollywood Entertainment stores. Growing through acquisitions, the company is heavily in debt. The recent rise of online video rental services, such as Netflix, is cutting into retail store revenues and reducing the company's cash flow. With just $135 million in cash at the end of 2005, Movie Gallery's management finds itself facing possible bankruptcy.

Preface

Welcome to the 13th edition of *Strategic Management and Business Policy*! Although the chapters are the same as those in the 12th edition, many of the cases are new and different. We completely revised seven of your favorite cases (**Apple, Dell, Google, Carnival, Panera Bread, Whole Foods,** and **Church & Dwight***)* and added 12 brand-new ones (**iRobot, Rosetta Stone, Logitech, Chrysler, Tesla Motors, TomTom, Volcom, TOMS Shoes, Best Buy, Dollar General, Boston Beer,** and **Burger King**) for a **total of 19 new cases**! More than half of the cases in this book are new to this edition! Although we still make a distinction between full-length and mini cases, we have interwoven them throughout the book to better identify them with their industries.

This edition continues the theme that runs throughout all 12 chapters: ***global environmental sustainability***. This strategic issue will become even more important in the years ahead, as all of us struggle to deal with the consequences of climate change, global warming, and energy availability. We continue to be the most comprehensive strategy book on the market, with chapters ranging from corporate governance and social responsibility to competitive strategy, functional strategy, and strategic alliances. To keep the size of the book manageable, we offer special issue chapters dealing with technology, entrepreneurship, and not-for-profit organizations on the Web site (www.pearsonhighered.com/wheelen).

FEATURES NEW TO THIS 13th EDITION

Nineteen New Cases: Both Full Length and Mini Length

Eleven full-length new or updated comprehensive cases and eight mini-length cases have been added to support the 16 popular full-length cases carried forward from past editions. Twelve of the cases are brand new. Seven are updated favorites from past editions. Of the 35 cases appearing in this book, 22 are exclusive and do not appear in other books.

- Five of the new cases deal with technology issues (**Apple, iRobot, Dell, Rosetta Stone,** and **Logitech**).
- One of the new cases deals with the Internet (**Google**).
- One new case involves entertainment (**Carnival**).
- Three new cases are of old and new transportation firms (**Chrysler, TomTom,** and **Tesla Motors**).
- Two new cases are of entrepreneurial clothing companies (**Volcom** and **TOMS Shoes**).
- Two new specialty retailing cases spotlight electronics (**Best Buy**) and variety (**Dollar General**).
- Five new cases come from the food, beverage, and restaurant industries (**Boston Beer, Panera Bread, Whole Foods Market, Burger King,** and **Church & Dwight**).

HOW THIS BOOK IS DIFFERENT FROM OTHER STRATEGY TEXTBOOKS

This book contains a **Strategic Management Model** that runs through the first 11 chapters and is made operational through the **Strategic Audit**, a complete case analysis methodology. The Strategic Audit provides a professional framework for case analysis in terms of external

and internal factors and takes the student through the generation of strategic alternatives and implementation programs.

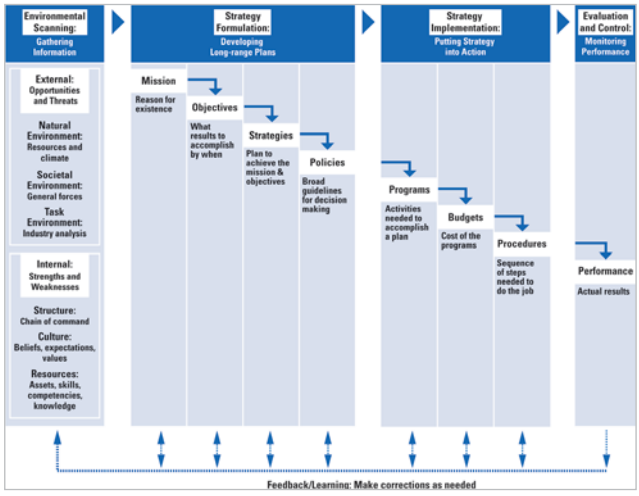
To help the student synthesize the many factors in a complex strategy case, we developed three useful techniques:

- **External Factor Analysis (EFAS) Table in Chapter 4**
  This reduces the external Opportunities and Threats to the 8 to 10 most important external factors facing management.
- **Internal Factor Analysis (IFAS) Table in Chapter 5**
  This reduces the internal Strengths and Weaknesses to the 8 to 10 most important internal factors facing management.
- **Strategic Factor Analysis Summary (SFAS) Matrix in Chapter 6**
  This condenses the 16 to 20 factors generated in the EFAS and IFAS Tables into the 8 to 10 most important (strategic) factors facing the company. These strategic factors become the basis for generating alternatives and a recommendation for the company's future direction.

Suggestions for Case Analysis are provided in **Appendix 12.B (end of Chapter 12)** and contain step-by-step procedures for how to use the Strategic Audit in analyzing a case. This appendix includes an example of a student-written Strategic Audit. Thousands of students around the world have applied this methodology to case analysis with great success. ***The Case Instructor's Manual*** contains examples of student-written Strategic Audits for each of the full-length comprehensive strategy cases.

FEATURES FOCUSED ON ENVIRONMENTAL SUSTAINABILITY

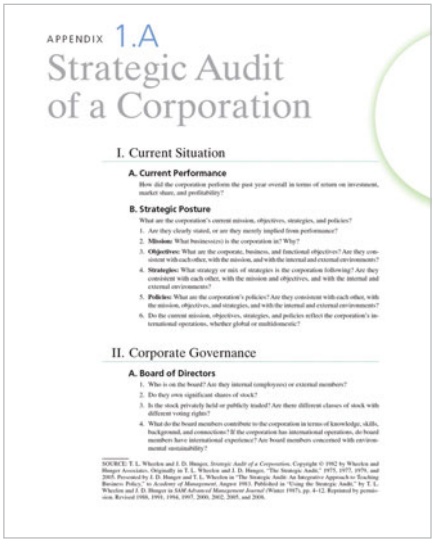
- Each chapter contains a boxed insert dealing with an issue in environmental sustainability.
- Each chapter ends with *Eco Bits*, interesting tidbits of ecological information, such as the number of plastic bags added to landfills each year.
- Special sections on sustainability are found in Chapters 1 and 3.
- A section on the natural environment is included in the societal and task environments in Chapter 4.



TIME-TESTED FEATURES

This edition contains many of the same features and content that helped make previous editions successful. Some of the features are the following:

- A **Strategic Management Model** runs throughout the first 11 chapters as a unifying concept. (Explained in ***Chapter 1***)


APPENDIX 1.A

Strategic Audit of a Corporation

I. Current Situation

A. Current Performance

How did the corporation perform the past year overall in terms of return on investment, market share, and profitability?

B. Strategic Posture

What are the corporation's current mission, objectives, strategies, and policies?

1. Are they clearly stated, or are they merely implied from performance?
2. **Mission:** What business(es) is the corporation in? Why?
3. **Objectives:** What are the corporate, business, and functional objectives? Are they consistent with each other, with the mission, and with the internal and external environments?
4. **Strategies:** What strategy or mix of strategies is the corporation following? Are they consistent with each other, with the mission and objectives, and with the internal and external environments?
5. **Policies:** What are the corporation's policies? Are they consistent with each other, with the mission, objectives, and strategies, and with the internal and external environments?
6. Do the current mission, objectives, strategies, and policies reflect the corporation's international operations, whether global or multidomestic?

II. Corporate Governance

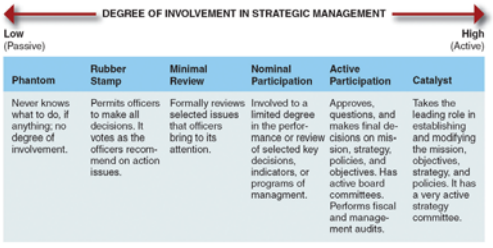
A. Board of Directors

1. Who is on the board? Are they internal (employees) or external members?
2. Do they own significant shares of stock?
3. Is the stock privately held or publicly traded? Are there different classes of stock with different voting rights?
4. What do the board members contribute to the corporation in terms of knowledge, skills, background, and connections? If the corporation has international operations, do board members have international experience? Are board members concerned with environmental sustainability?

SOURCE: T. L. Wheelen and J. D. Hunger, *Strategic Audit of a Corporation*. Copyright © 1982 by Wheelen and Hunger Associates. Originally in T. L. Wheelen and J. D. Hunger, "The Strategic Audit," 1975, 1979, and 2005. Presented by J. D. Hunger and T. L. Wheelen in "The Strategic Audit: An Integrative Approach to Teaching Business Policy," to *Academy of Management*, August 1983. Published in "Using the Strategic Audit," by T. L. Wheelen and J. D. Hunger in *SAM Advanced Management Journal* (Winter 1987), pp. 4–12. Reprinted by permission. Revised 1988, 1991, 1994, 1997, 2000, 2002, 2005, and 2008.

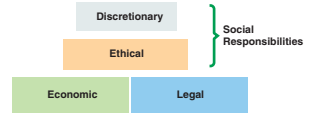
- The **Strategic Audit**, a way to operationalize the strategic decision-making process, serves as a checklist in case analysis. (***Chapter 1***)
- **Corporate governance** is examined in terms of the roles, responsibilities, and interactions of top management and the board of directors and includes the impact of the Sarbanes-Oxley Act. (***Chapter 2***)

FIGURE 2–1 Board of Directors Continuum



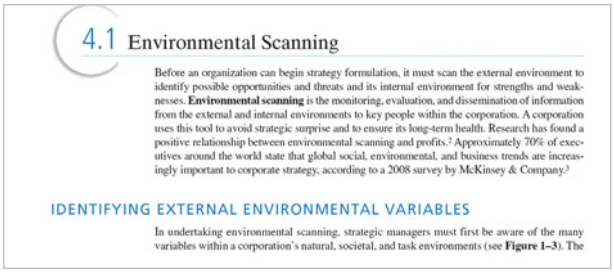
SOURCE: T. L. Wheelen and J. D. Hunger, "Board of Directors Continuum," Copyright © 1994 by Wheelen and Hunger Associates. Reprinted by permission.

FIGURE 3–1 Responsibilities of Business



SOURCE: Based on A. B. Carroll, "A Three Dimensional Conceptual Model of Corporate Performance," *Academy of Management Review* (October 1979), pp. 497–505; A. B. Carroll, "Managing Ethically with Global Stakeholders: A Present and Future Challenge," *Academy of Management Executive* (May 2004), pp. 114–120; and A. B. Carroll, "The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders," *Business Horizons* (July–August 1991), pp. 39–48.

- **Social responsibility and managerial ethics** are examined in detail in terms of how they affect strategic decision making. They include the process of stakeholder analysis and the concept of social capital. (***Chapter 3***)


4.1 Environmental Scanning

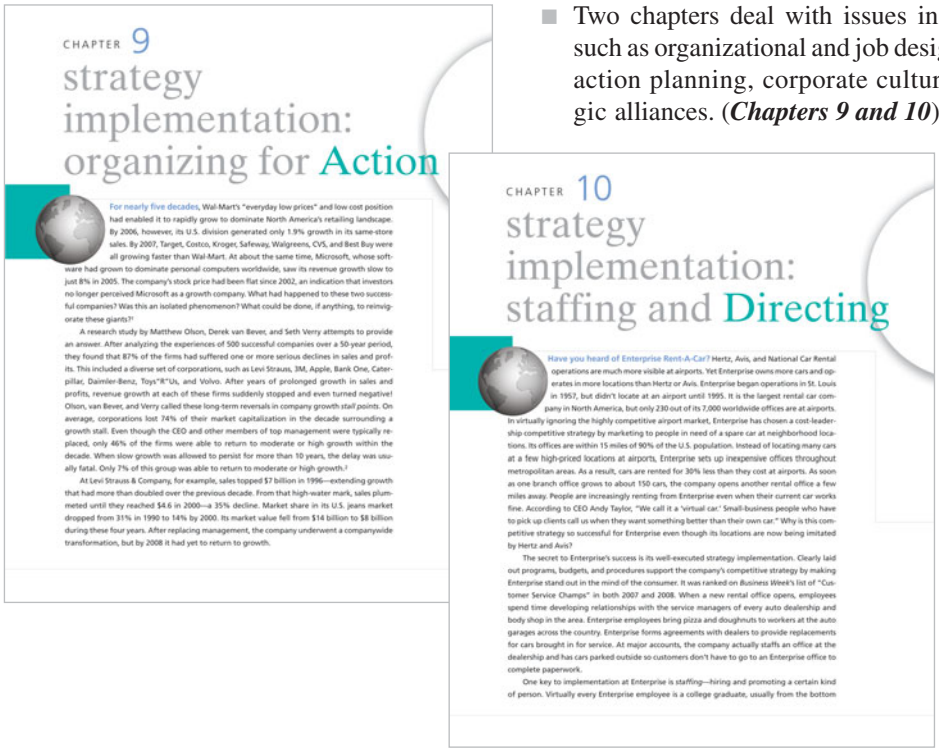
Before an organization can begin strategy formulation, it must scan the external environment to identify possible opportunities and threats and its internal environment for strengths and weaknesses. **Environmental scanning** is the monitoring, evaluation, and dissemination of information from the external and internal environments to key people within the corporation. A corporation uses this tool to avoid strategic surprise and to ensure its long-term health. Research has found a positive relationship between environmental scanning and profits.[2] Approximately 70% of executives around the world state that global social, environmental, and business trends are increasingly important to corporate strategy, according to a 2008 survey by McKinsey & Company.[3]

IDENTIFYING EXTERNAL ENVIRONMENTAL VARIABLES

In undertaking environmental scanning, strategic managers must first be aware of the many variables within a corporation's natural, societal, and task environments (see **Figure 1–3**). The

- Equal emphasis is placed on **environmental scanning** of the societal environment as well as on the task environment. Topics include forecasting and Miles and Snow's typology in addition to competitive intelligence techniques and Porter's industry analysis. (***Chapter 4***)

- **Core and distinctive competencies** are examined within the framework of the resource-based view of the firm. (***Chapter 5***)
- **Organizational analysis** includes material on business models, supply chain management, and corporate reputation. (***Chapter 5***)
- Internal and external strategic factors are emphasized through the use of specially designed **EFAS, IFAS**, and **SFAS tables**. (***Chapters 4, 5, and 6***)
- **Functional strategies** are examined in light of **outsourcing.** (***Chapter 8***)



CHAPTER 9
strategy implementation: organizing for Action

For nearly five decades, Wal-Mart's "everyday low prices" and low cost position had enabled it to rapidly grow to dominate North America's retailing landscape. By 2006, however, its U.S. division generated only 1.9% growth in its same-store sales. By 2007, Target, Costco, Kroger, Safeway, Walgreens, CVS, and Best Buy were all growing faster than Wal-Mart. At about the same time, Microsoft, whose software had grown to dominate personal computers worldwide, saw its revenue growth slow to just 8% in 2005. The company's stock price had been flat since 2002, an indication that investors no longer perceived Microsoft as a growth company. What had happened to these two successful companies? Was this an isolated phenomenon? What could be done, if anything, to reinvigorate these giants?[1]

A research study by Matthew Olson, Derek van Bever, and Seth Verry attempts to provide an answer. After analyzing the experiences of 500 successful companies over a 50-year period, they found that 87% of the firms had suffered one or more serious declines in sales and profits. This included a diverse set of corporations, such as Levi Strauss, 3M, Apple, Bank One, Caterpillar, Daimler-Benz, Toys"R"Us, and Volvo. After years of prolonged growth in sales and profits, revenue growth at each of these firms suddenly stopped and even turned negative! Olson, van Bever, and Verry called these long-term reversals in company growth *stall points*. On average, corporations lost 74% of their market capitalization in the decade surrounding a growth stall. Even though the CEO and other members of top management were typically replaced, only 46% of the firms were able to return to moderate or high growth within the decade. When slow growth was allowed to persist for more than 10 years, the delay was usually fatal. Only 7% of this group was able to return to moderate or high growth.[2]

At Levi Strauss & Company, for example, sales topped $7 billion in 1996—extending growth that had more than doubled over the previous decade. From that high-water mark, sales plummeted until they reached $4.6 in 2000—a 35% decline. Market share in its U.S. jeans market dropped from 31% in 1990 to 14% by 2000. Its market value fell from $14 billion to $8 billion during these four years. After replacing management, the company underwent a companywide transformation, but by 2008 it had yet to return to growth.

CHAPTER 10
strategy implementation: staffing and Directing

Have you heard of Enterprise Rent-A-Car? Hertz, Avis, and National Car Rental operations are much more visible at airports. Yet Enterprise owns more cars and operates in more locations than Hertz or Avis. Enterprise began operations in St. Louis in 1957, but didn't locate at an airport until 1995. It is the largest rental car company in North America, but only 230 out of its 7,000 worldwide offices are at airports. In virtually ignoring the highly competitive airport market, Enterprise has chosen a cost-leadership competitive strategy by marketing to people in need of a spare car at neighborhood locations. Its offices are within 15 miles of 90% of the U.S. population. Instead of locating many cars at a few high-priced locations at airports, Enterprise sets up inexpensive offices throughout metropolitan areas. As a result, cars are rented for 30% less than they cost at airports. As soon as one branch office grows to about 150 cars, the company opens another rental office a few miles away. People are increasingly renting from Enterprise even when their current car works fine. According to CEO Andy Taylor, "We call it a 'virtual car.' Small-business people who have to pick up clients call us when they want something better than their own car." Why is this competitive strategy so successful for Enterprise even though its locations are now being imitated by Hertz and Avis?

The secret to Enterprise's success is its well-executed strategy implementation. Clearly laid out programs, budgets, and procedures support the company's competitive strategy by making Enterprise stand out in the mind of the consumer. It was ranked on *Business Week*'s list of "Customer Service Champs" in both 2007 and 2008. When a new rental office opens, employees spend time developing relationships with the service managers of every auto dealership and body shop in the area. Enterprise employees bring pizza and doughnuts to workers at the auto garages across the country. Enterprise forms agreements with dealers to provide replacements for cars brought in for service. At major accounts, the company actually staffs an office at the dealership and has cars parked outside so customers don't have to go to an Enterprise office to complete paperwork.

One key to implementation at Enterprise is *staffing*—hiring and promoting a certain kind of person. Virtually every Enterprise employee is a college graduate, usually from the bottom

- Two chapters deal with issues in **strategy implementation**, such as organizational and job design plus strategy-manager fit, action planning, corporate culture, and international strategic alliances. (***Chapters 9 and 10***)

- A separate chapter on **evaluation and control** explains the importance of measurement and incentives to organizational performance. (***Chapter 11***)

- **Suggestions for in-depth case analysis** provide a complete listing of financial ratios, recommendations for oral and written analysis, and ideas for further research. (***Chapter 12***)

TABLE 12–1 Financial Ratio Analysis

	Formula	How Expressed	Meaning
1. Liquidity Ratios Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Decimal	A short-term indicator of the company's ability to pay its short-term liabilities from short-term assets; how much of current assets are available to cover each dollar of current liabilities.
Quick (acid test) ratio	$\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$	Decimal	Measures the company's ability to pay off its short-term obligations from current assets, excluding inventories.
Inventory to net working capital	$\frac{\text{Inventory}}{\text{Current assets} - \text{Current liabilities}}$	Decimal	A measure of inventory balance; measures the extent to which the cushion of excess current assets over current liabilities may be threatened by unfavorable changes in inventory.
Cash ratio	$\frac{\text{Cash} + \text{Cash equivalents}}{\text{Current liabilities}}$	Decimal	Measures the extent to which the company's capital is in cash or cash equivalents; shows how much of the current obligations can be paid from cash or near-cash assets.
2. Profitability Ratios Net profit margin	$\frac{\text{Net profit after taxes}}{\text{Net sales}}$	Percentage	Shows how much after-tax profits are generated by each dollar of sales.
Gross profit margin	$\frac{\text{Sales} - \text{Cost of goods sold}}{\text{Net sales}}$	Percentage	Indicates the total margin available to cover other expenses beyond cost of goods sold and still yield a profit.
Return on investment (ROI)	$\frac{\text{Net profit after taxes}}{\text{Total assets}}$	Percentage	Measures the rate of return on the total assets utilized in the company; a measure of management's efficiency, it shows the return on all the assets under its control, regardless of source of financing.
Return on equity (ROE)	$\frac{\text{Net profit after taxes}}{\text{Shareholders' equity}}$	Percentage	Measures the rate of return on the book value of shareholders' total investment in the company.
Earnings per share (EPS)	$\frac{\text{Net profit after taxes} - \text{Preferred stock dividends}}{\text{Average number of common shares}}$	Dollars per share	Shows the after-tax earnings generated for each share of common stock.
3. Activity Ratios Inventory turnover	$\frac{\text{Net sales}}{\text{Inventory}}$	Decimal	Measures the number of times that average inventory of finished goods was turned over or sold during a period of time, usually a year.
Days of inventory	$\frac{\text{Inventory}}{\text{Cost of goods sold} \div 365}$	Days	Measures the number of one day's worth of inventory that a company has on hand at any given time.

FIGURE 12–1
Strategic Audit Worksheet

Strategic Audit Heading	Analysis (+) Factors	Analysis (–) Factors	Comments
I. Current Situation			
A. Past Corporate Performance Indexes			
B. Strategic Posture: Current Mission, Current Objectives, Current Strategies, Current Policies			
SWOT Analysis Begins:			
II. Corporate Governance			
A. Board of Directors			
B. Top Management			
III. External Environment (EFAS): Opportunities and Threats (SWOT)			
A. Societal Environment			
B. Task Environment (Industry Analysis)			
IV. Internal Environment (IFAS): Strengths and Weaknesses (SWOT)			
A. Corporate Structure			
B. Corporate Culture			
C. Corporate Resources			
1. Marketing			
2. Finance			
3. Research and Development			
4. Operations and Logistics			
5. Human Resources			
6. Information Systems			
V. Analysis of Strategic Factors (SFAS)			
A. Key Internal and External Strategic Factors (SWOT)			
B. Review of Mission and Objectives			
SWOT Analysis Ends. Recommendation Begins:			
VI. Alternatives and Recommendations			
A. Strategic Alternatives—pros and cons			
B. Recommended Strategy			
VII. Implementation			
VIII. Evaluation and Control			

NOTE: See the complete Strategic Audit on pages 26–33. It lists the pages in the book that discuss each of the eight headings.

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- The **Strategic Audit Worksheet** is based on the time-tested Strategic Audit and is designed to help students organize and structure daily case preparation in a brief period of time. The worksheet works exceedingly well for checking the level of daily student case preparation—especially for open class discussions of cases. (***Chapter 12***)
- Special chapters deal with strategic issues in **managing technology and innovation**, **entrepreneurial ventures and small businesses**, and **not-for-profit organizations**. (**Web *Chapters A, B, and C***, respectively) These issues are often ignored by other strategy textbooks, but are available on this book's Web site at www.pearsonhighered.com/wheelen.

- An **experiential exercise** focusing on the material covered in each chapter helps the reader to apply strategic concepts to an actual situation.

STRATEGIC PRACTICE EXERCISE

Each year, *Fortune* magazine publishes an article entitled, "America's Most Admired Companies." It lists the 10 most admired companies in the United States and in the world. *Fortune*'s rankings are based on scoring publicly held companies on what it calls "eight key attributes of reputation": innovation, people management, use of corporate assets, social responsibility, quality of management, financial soundness, long-term investment value, and quality of products/services. In 2008, *Fortune* asked Hay Group to survey more than 3,700 people from multiple industries. Respondents were asked to choose the companies they admired most, regardless of industry. *Fortune* has been publishing this list since 1982. The *2008 Fortune* list of the top 10 most admired U.S. companies were (starting with #1): Apple, Berkshire Hathaway, General Electric, Google, Toyota Motor, Starbucks, FedEx, Procter & Gamble, Johnson & Johnson, and Goldman Sachs Group. The next 10 most admired were (from 11 to 20): Target, Southwest Airlines, American Express, BMW, Costco Wholesale, Microsoft, United Parcel Service, Cisco Systems, 3M, and Nordstrom.[114]

Four years earlier in 2004, the list of 10 most admired U.S. companies was: Wal-Mart, Berkshire Hathaway, Southwest Airlines, General Electric, Dell Computer, Microsoft, Johnson & Johnson, Starbucks, FedEx, and IBM.[115]

- Why did the most admired U.S. firm in 2004 (Wal-Mart) drop off the 10 ten listing in 2008?
- Why did Apple go from not even being on the 10 ten U.S. listing in 2004 to No. 1 in 2008?
- Which firms appeared on both top 10 lists? Why?
- Why did some firms drop off the list from 2004 to 2008 and why did others get included?
- What companies should be on the most admired list this year? Why?

Try One of These Exercises

1. Go to the library and find a "Most Admired Companies" *Fortune* article from the 1980s or early 1990s and compare that list to the latest one. (See www.fortune.com for the latest list.) Which companies have fallen out of the top 10? Pick one of the companies and investigate why it is no longer on the list.

- A list of **key terms** and the pages in which they are discussed enable the reader to keep track of important concepts as they are introduced in each chapter.
- **Learning objectives** begin each chapter.
- **Each Part ends with a short case that acts to integrate the material discussed within the previous chapters.**
- **Timely, well-researched, and class-tested cases** deal with interesting companies and industries. Many of the cases are about well-known, publicly held corporations—ideal subjects for further research by students wishing to "update" the cases.

Both the text and the cases have been class-tested in strategy courses and revised based on feedback from students and instructors. The first 11 chapters are organized around a Strategic Management Model that begins each chapter and provides a structure for both content and case analysis. We emphasize those concepts that have proven to be most useful in understanding strategic decision making and in conducting case analysis. Our goal was to make the text as comprehensive as possible without getting bogged down in any one area. Endnote references are provided for those who wish to learn more about any particular topic. All cases are about actual organizations. The firms range in size from large, established multinationals to small, entrepreneurial ventures, and cover a broad variety of issues. As an aid to case analysis, we propose the Strategic Audit as an analytical technique.

SUPPLEMENTS

Instructor Resource Center

At www.pearsonhighered.com/irc, instructors can access teaching resources available with this text in downloadable, digital format. Registration is simple and gives you immediate access to new titles and new editions. As a registered faculty member, you can download resource files and receive immediate access and instructions for installing course management content on your campus server. In case you ever need assistance, our dedicated technical support team is ready to assist instructors with questions about the media supplements that accompany this text. Visit http://247.pearsoned.com/ for answers to frequently asked questions and toll-free user support phone numbers. The Instructor Resource Center provides the following electronic resources.

Instructor's Manuals

Two comprehensive Instructor's Manuals have been carefully constructed to accompany this book. The first one accompanies the concepts chapters; the second one accompanies the cases.

Concepts Instructor's Manual

To aid in discussing the 12 strategy chapters as well as the three web special issue chapters, the *Concepts Instructor's Manual* includes:

- **Suggestions for Teaching Strategic Management:** These include various teaching methods and suggested course syllabi.
- **Chapter Notes:** These include summaries of each chapter, suggested answers to discussion questions, and suggestions for using end-of-chapter cases/exercises and part-ending cases, plus additional discussion questions (with answers) and lecture modules.

Case Instructor's Manual

To aid in case method teaching, the *Case Instructor's Manual* includes detailed suggestions for use, teaching objectives, and examples of student analyses for each of the full-length comprehensive cases. This is the most comprehensive Instructor's Manual available in strategic management. A standardized format is provided for each case:

1. Case Abstract
2. Case Issues and Subjects
3. Steps Covered in the Strategic Decision-Making Process
4. Case Objectives
5. Suggested Classroom Approaches
6. Discussion Questions
7. Case Author's Teaching Note
8. Student-Written Strategic Audit, if appropriate
9. EFAS, IFAS, and SFAS Exhibits
10. Financial Analysis—ratios and common-size income statements, if appropriate

PowerPoint Slides

PowerPoint slides, provided in a comprehensive package of text outlines and figures corresponding to the text, are designed to aid the educator and supplement in-class lectures.

Test Item File

This Test Item File contains over 1,200 questions, including multiple-choice, true/false, and essay questions. Each question is followed by the correct answer, page reference, AACSB category, and difficulty rating.

TestGen

TestGen software is preloaded with all of the *Test Item File* questions. It allows instructors to manually or randomly view test questions, and to add, delete, or modify test-bank questions as needed to create multiple tests.

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Exciting and high-quality video clips help deliver engaging topics to the classroom to help students better understand the concepts explained in the textbook. Please contact your local representative to receive a copy of the DVD.

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Lastly, to the many strategy instructors and students who have moaned to us about their problems with the strategy course: We have tried to respond to your problems and concerns as best we could by providing a comprehensive yet usable text coupled with recent and complex cases. To you, the people who work hard in the strategy trenches, we acknowledge our debt. This book is yours.

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THIRTEENTH EDITION

Strategic Management and Business Policy

TOWARD GLOBAL SUSTAINABILITY

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PART 1

Introduction to Strategic Management and Business Policy

CHAPTER 1

basic concepts of Strategic Management

How does a company become successful and stay successful? Certainly not by playing it safe and following the traditional ways of doing business! Taking a strategic risk is what General Electric (GE) did when it launched its *Ecomagination* strategic initiative in 2005. According to Jeffrey Immelt, Chairman and CEO:

> Ecomagination is GE's commitment to address challenges, such as the need for cleaner, more efficient sources of energy, reduced emissions, and abundant sources of clean water. And we plan to make money doing it. Increasingly for business, "green" is green.[1]

Immelt announced in a May 9, 2005, conference call that the company planned to more than double its spending on research and development from $700 million in 2004 to $1.5 billion by 2010 for cleaner products ranging from power generation to locomotives to water processing. The company intended to introduce 30 to 40 new products, including more efficient lighting and appliances, over the next two years. It also expected to double revenues from businesses that made wind turbines, treat water, and reduce greenhouse-emitting gases to at least $20 billion by 2010. In addition to working with customers to develop more efficient power generators, the company planned to reduce its own emission of greenhouse gases by 1% by 2012 and reduce the intensity of those gases 30% by 2008.[2] In 2006, GE's top management informed the many managers of its global business units that in the future they would be judged not only by the usual measures, such as return on capital, but that they would also be accountable for achieving corporate environmental objectives.

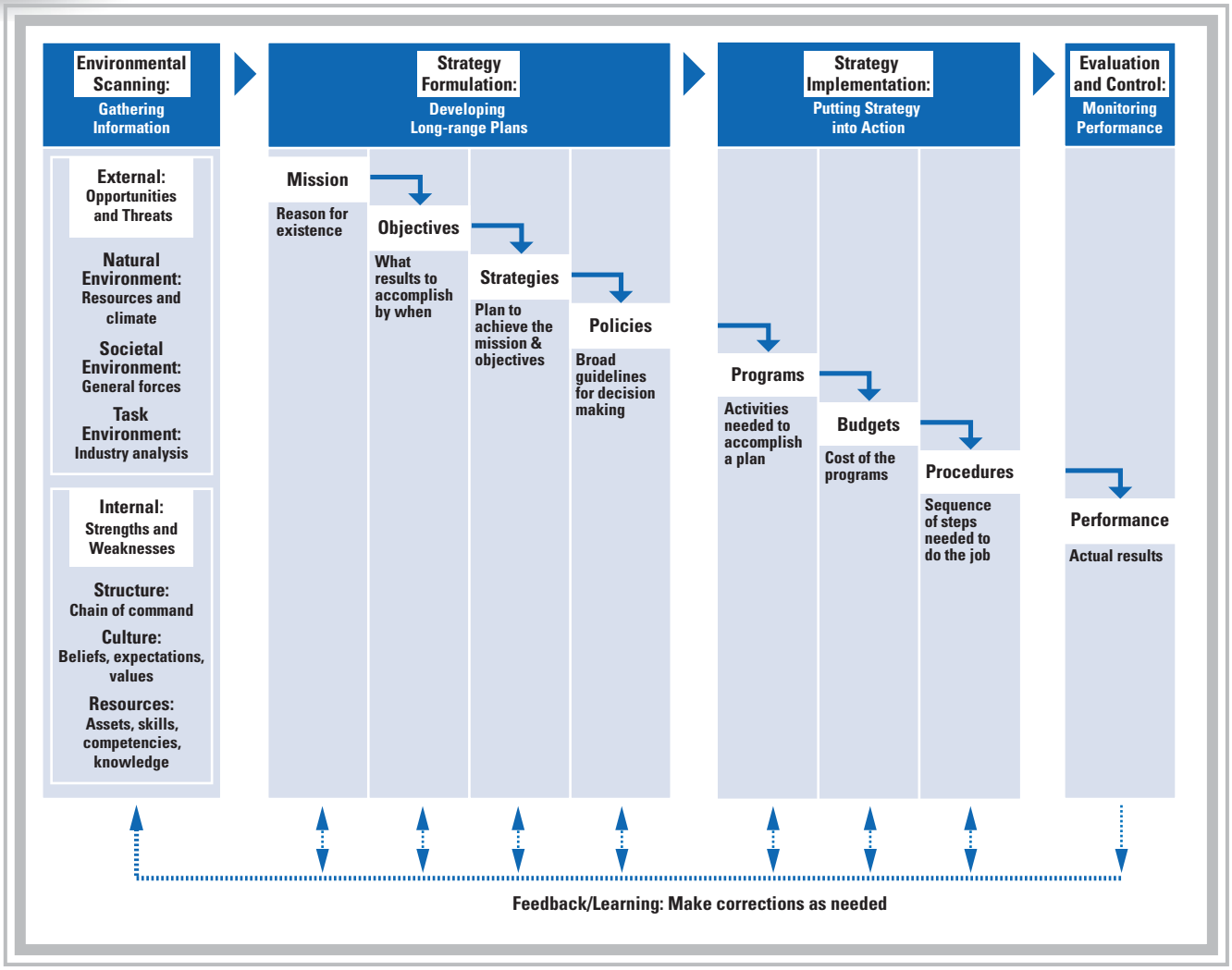
Ecomagination was a strategic change for GE, a company that had previously been condemned by environmentalists for its emphasis on coal and nuclear power and for polluting the Hudson and Housatonic rivers with polychlorinated biphenyls (PCBs) in the 1980s. Over the years, GE had been criticized for its lack of social responsibility and for its emphasis on profitability and financial performance over social and environmental objectives. What caused GE's management to make this strategic change?

In the 18 months before launching its new environmental strategy, GE invited managers from companies in various industries to participate in two-day "dreaming sessions" during which they were asked to imagine life in 2015—and the products they, as customers, would need from GE. The consensus was a future of rising fuel costs, restrictive environmental regulations, and growing consumer expectations for cleaner technologies, especially in the energy industry. Based on this conclusion, GE's management made the strategic decision to move in a new

Learning Objectives

After reading this chapter, you should be able to:

- Understand the benefits of strategic management
- Explain how globalization and environmental sustainability influence strategic management
- Understand the basic model of strategic management and its components
- Identify some common triggering events that act as stimuli for strategic change
- Understand strategic decision-making modes
- Use the strategic audit as a method of analyzing corporate functions and activities



direction. According to Vice Chairman David Calhoun, "We decided that if this is what our customers want, let's stop putting our heads in the sand, dodging environmental interests, and go from defense to offense."[3]

Following GE's announcement of its new strategic initiative, analysts raised questions regarding the company's ability to make Ecomagination successful. They not only questioned CEO Immelt's claim that green could be profitable as well as socially responsible, but they also wondered if Immelt could transform GE's incremental approach to innovation to one of pursuing riskier technologies, such as fuel cells, solar energy, hydrogen storage, and nanotechnology.[4] Other companies had made announcements of green initiatives, only to leave them withering on the vine when they interfered with profits. For example, FedEx had announced in 2003 that it would soon be deploying clean-burning hybrid trucks at a rate of 3,000 per year, eventually cutting emissions by 250,000 tons of greenhouse gases. Four years later, FedEx had purchased fewer than 100 hybrid vehicles, less than 1% of its fleet! With hybrid trucks costing 75% more than conventional trucks, it would take 10 years for the fuel savings to pay for the costly vehicles. FedEx management concluded that breaking even over a 10-year period was not the best use of company capital. As a result of this and other experiences, skeptics felt that most large companies were only indulging in *greenwash* when they talked loudly about their sustainability efforts, but followed through with very little actual results.[5]

CEO Immelt had put his reputation at risk by personally leading GE's Ecomagination initiative. Skeptics wondered if the environmental markets would materialize and if they would be as profitable as demanded by GE's shareholders. Would a corporate culture known for its pursuit of the Six Sigma statistics-based approach to quality control be able to create technological breakthroughs and new green businesses? If Immelt was correct, not only would GE benefit, but other companies would soon follow GE's lead. If, however, he was wrong, Immelt would have led his company down a dead end where it would be difficult to recover from the damage to its reputation and financial standing. According to a 25-year veteran of GE, "Jeff is asking us to take a really big swing . . . . This is hard for us."[6]

1.1 The Study of Strategic Management

Strategic management is a set of managerial decisions and actions that determines the long-run performance of a corporation. It includes environmental scanning (both external and internal), strategy formulation (strategic or long-range planning), strategy implementation, and evaluation and control. The study of strategic management, therefore, emphasizes the monitoring and evaluating of external opportunities and threats in light of a corporation's strengths and weaknesses. Originally called *business policy*, strategic management incorporates such topics as strategic planning, environmental scanning, and industry analysis.

PHASES OF STRATEGIC MANAGEMENT

Many of the concepts and techniques that deal with strategic management have been developed and used successfully by business corporations such as General Electric and the Boston Consulting Group. Over time, business practitioners and academic researchers have expanded and refined these concepts. Initially, strategic management was of most use to large corporations operating in multiple industries. Increasing risks of error, costly mistakes, and even economic ruin are causing today's professional managers in all organizations to take strategic management seriously in order to keep their companies competitive in an increasingly volatile environment.

As managers attempt to better deal with their changing world, a firm generally evolves through the following four **phases of strategic management**:[7]

Phase 1—Basic financial planning: Managers initiate serious planning when they are requested to propose the following year's budget. Projects are proposed on the basis of very little analysis, with most information coming from within the firm. The sales force usually provides the small amount of environmental information. Such simplistic operational planning only pretends to be strategic management, yet it is quite time consuming. Normal company activities are often suspended for weeks while managers try to cram ideas into the proposed budget. The time horizon is usually one year.

Phase 2—Forecast-based planning: As annual budgets become less useful at stimulating long-term planning, managers attempt to propose five-year plans. At this point they consider projects that may take more than one year. In addition to internal information, managers gather any available environmental data—usually on an ad hoc basis—and extrapolate current trends five years into the future. This phase is also time consuming, often involving a full month of managerial activity to make sure all the proposed budgets fit together. The process gets very political as managers compete for larger shares of funds. Endless meetings take place to evaluate proposals and justify assumptions. The time horizon is usually three to five years.

Phase 3—Externally oriented (strategic) planning: Frustrated with highly political yet ineffectual five-year plans, top management takes control of the planning process by initiating strategic planning. The company seeks to increase its responsiveness to changing markets and competition by thinking strategically. Planning is taken out of the hands of lower-level managers and concentrated in a planning staff whose task is to develop strategic plans for the corporation. Consultants often provide the sophisticated and innovative techniques that the planning staff uses to gather information and forecast future trends. Ex-military experts develop competitive intelligence units. Upper-level managers meet once a year at a resort "retreat" led by key members of the planning staff to evaluate and update the current strategic plan. Such top-down planning emphasizes formal strategy formulation and leaves the implementation issues to lower management levels. Top management typically develops five-year plans with help from consultants but minimal input from lower levels.

Phase 4—Strategic management: Realizing that even the best strategic plans are worthless without the input and commitment of lower-level managers, top management forms planning groups of managers and key employees at many levels, from various departments and workgroups. They develop and integrate a series of strategic plans aimed at achieving the company's primary objectives. Strategic plans at this point detail the implementation, evaluation, and control issues. Rather than attempting to perfectly forecast the future, the plans emphasize probable scenarios and contingency strategies. The sophisticated annual five-year strategic plan is replaced with strategic thinking at all levels of the organization throughout the year. Strategic information, previously available only centrally to top management, is available via local area networks and intranets to people throughout the organization. Instead of a large centralized planning staff, internal and external planning consultants are available to help guide group strategy discussions. Although top management may still initiate the strategic planning process, the resulting strategies may come from anywhere in the organization. Planning is typically interactive across levels and is no longer top down. People at all levels are now involved.

General Electric, one of the pioneers of strategic planning, led the transition from strategic planning to strategic management during the 1980s.[8] By the 1990s, most other corporations around the world had also begun the conversion to strategic management.

BENEFITS OF STRATEGIC MANAGEMENT

Strategic management emphasizes long-term performance. Many companies can manage short-term bursts of high performance, but only a few can sustain it over a longer period of time. For example, of the original *Forbes 100* companies listed in 1917, only 13 have survived to the present day. To be successful in the long-run, companies must not only be able to *execute* current activities to satisfy an existing market, but they must also *adapt* those activities to satisfy new and changing markets.[9]

Research reveals that organizations that engage in strategic management generally outperform those that do not.[10] The attainment of an appropriate match, or "fit," between an organization's environment and its strategy, structure, and processes has positive effects on the organization's performance.[11] Strategic planning becomes increasingly important as the environment becomes more unstable.[12] For example, studies of the impact of deregulation on the U.S. railroad and trucking industries found that companies that changed their strategies and structures as their environment changed outperformed companies that did not change.[13]

A survey of nearly 50 corporations in a variety of countries and industries found the three most highly rated benefits of strategic management to be:

- Clearer sense of strategic vision for the firm.
- Sharper focus on what is strategically important.
- Improved understanding of a rapidly changing environment.[14]

A recent survey by McKinsey & Company of 800 executives found that formal strategic planning processes improve overall satisfaction with strategy development.[15] To be effective, however, strategic management need not always be a formal process. It can begin with a few simple questions:

1. Where is the organization now? (Not where do we hope it is!)
2. If no changes are made, where will the organization be in one year? two years? five years? 10 years? Are the answers acceptable?
3. If the answers are not acceptable, what specific actions should management undertake? What are the risks and payoffs involved?

Bain & Company's *2007 Management Tools and Trends* survey of 1,221 global executives revealed strategic planning to be the most used management tool—used by 88% of respondents. Strategic planning is particularly effective at identifying new opportunities for growth and in ensuring that all managers have the same goals.[16] Other highly-ranked strategic management tools were mission and vision statements (used by 79% of respondents), core competencies (79%), scenario and contingency planning (69%), knowledge management (69%), strategic alliances (68%), and growth strategy tools (65%).[17] A study by Joyce, Nohria, and Roberson of 200 firms in 50 subindustries found that devising and maintaining an engaged, focused strategy was the first of four essential management practices that best differentiated between successful and unsuccessful companies.[18] Based on these and other studies, it can be concluded that strategic management is crucial for long-term organizational success.

Research into the planning practices of companies in the oil industry concludes that the real value of modern strategic planning is more in the *strategic thinking* and *organizational learning* that is part of a future-oriented planning process than in any resulting written strategic plan.[19] Small companies, in particular, may plan informally and irregularly. Nevertheless, studies of small- and medium-sized businesses reveal that the greater the level of planning intensity, as measured by the presence of a formal strategic plan, the greater the level of financial performance, especially when measured in terms of sales increases.[20]

Planning the strategy of large, multidivisional corporations can be complex and time consuming. It often takes slightly more than a year for a large company to move from situation assessment to a final decision agreement. For example, strategic plans in the global oil industry tend to cover four to five years. The planning horizon for oil exploration is even longer—up to 15 years.[21] Because of the relatively large number of people affected by a strategic decision in a large firm, a formalized, more sophisticated system is needed to ensure that strategic planning leads to successful performance. Otherwise, top management becomes isolated from developments in the business units, and lower-level managers lose sight of the corporate mission and objectives.

1.2 Globalization and Environmental Sustainability: Challenges to Strategic Management

Not too long ago, a business corporation could be successful by focusing only on making and selling goods and services within its national boundaries. International considerations were minimal. Profits earned from exporting products to foreign lands were considered frosting on the cake, but not really essential to corporate success. During the 1960s, for example, most U.S. companies organized themselves around a number of product divisions that made and sold goods only in the United States. All manufacturing and sales outside the United States were typically managed through one international division. An international assignment was usually considered a message that the person was no longer promotable and should be looking for another job.

Similarly, until the later part of the 20th century, a business firm could be very successful without being environmentally sensitive. Companies dumped their waste products in nearby streams or lakes and freely polluted the air with smoke containing noxious gases. Responding to complaints, governments eventually passed laws restricting the freedom to pollute the environment. Lawsuits forced companies to stop old practices. Nevertheless, until the dawn of the 21st century, most executives considered pollution abatement measures to be a cost of business that should be either minimized or avoided. Rather than clean up a polluting manufacturing site, they often closed the plant and moved manufacturing offshore to a developing nation with fewer environmental restrictions. Sustainability, as a term, was used to describe competitive advantage, not the environment.

IMPACT OF GLOBALIZATION

Today, everything has changed. **Globalization**, the integrated internationalization of markets and corporations, has changed the way modern corporations do business. As Thomas Friedman points out in *The World Is Flat*, jobs, knowledge, and capital are now able to move across borders with far greater speed and far less friction than was possible only a few years ago.[22] For example, the inter-connected nature of the global financial community meant that the mortgage lending problems of U.S. banks led to a global financial crisis in 2008. The worldwide availability of the Internet and supply-chain logistical improvements, such as containerized shipping, mean that companies can now locate anywhere and work with multiple partners to serve any market. To reach the economies of scale necessary to achieve the low costs, and thus the low prices, needed to be competitive, companies are now thinking of a global market instead of national markets. Nike and Reebok, for example, manufacture their athletic shoes in various countries throughout Asia for sale on every continent. Many other companies in North America and Western Europe are outsourcing their manufacturing, software development, or customer service to companies in China, Eastern Europe, or India. Large pools of talented software programmers, English language proficiency, and lower wages in India enables IBM to employ 75,000 people in its global delivery centers in Bangalore, Delhi, or Kolkata to serve the needs of clients in Atlanta, Munich, or Melbourne.[23] Instead of using one international division to manage everything outside the home country, large corporations are now using matrix structures in which product units are interwoven with country or regional units. International assignments are now considered key for anyone interested in reaching top management.

As more industries become global, strategic management is becoming an increasingly important way to keep track of international developments and position a company for long-term competitive advantage. For example, General Electric moved a major research and development lab for its medical systems division from Japan to China in order to learn more about developing new products for developing economies. Microsoft's largest research center outside Redmond, Washington, is in Beijing. According to Wilbur Chung, a Wharton professor, "Whatever China develops is rolled out to the rest of the world. China may have a lower GDP per-capita than developed countries, but the Chinese have a strong sense of how products should be designed for their market."[24]

The formation of regional trade associations and agreements, such as the European Union, NAFTA, Mercosur, Andean Community, CAFTA, and ASEAN, is changing how international business is being conducted. See the **Global Issue** feature to learn how regional trade associations are forcing corporations to establish a manufacturing presence wherever they wish to market goods or else face significant tariffs. These associations have led to the increasing harmonization of standards so that products can more easily be sold and moved across national boundaries. International considerations have led to the strategic alliance between British Airways and American Airlines and to the acquisition of the Miller Brewing Company by South African Breweries (SAB), among others.

IMPACT OF ENVIRONMENTAL SUSTAINABILITY

Environmental sustainability refers to the use of business practices to reduce a company's impact upon the natural, physical environment. Climate change is playing a growing role in business decisions. More than half of the global executives surveyed by McKinsey & Company in 2007 selected "environmental issues, including climate change," as the most important issue facing them over the next five years.[25] A 2005 survey of 27 large, publicly-held, multinational corporations based in North America revealed that 90% believed that government regulation was

GLOBAL issue

REGIONAL TRADE ASSOCIATIONS REPLACE NATIONAL TRADE BARRIERS

Formed as the European Economic Community in 1957, the **European Union (EU)** is the most significant trade association in the world. The goal of the EU is the complete economic integration of its 27 member countries so that goods made in one part of Europe can move freely without ever stopping for a customs inspection. The EU includes Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the United Kingdom. Others, including Croatia, Macedonia, and Turkey, have either recently applied or are in the process of applying. The EU is less than half the size of the United States of America, but has 50% more population. One currency, the euro, is being used throughout the region as members integrate their monetary systems. The steady elimination of barriers to free trade is providing the impetus for a series of mergers, acquisitions, and joint ventures among business corporations. The requirement of at least 60% local content to avoid tariffs has forced many U.S. and Asian companies to abandon exporting in favor of having a strong local presence in Europe.

Canada, the United States, and Mexico are affiliated economically under the **North American Free Trade Agreement (NAFTA)**. The goal of NAFTA is improved trade among the three member countries rather than complete economic integration. Launched in 1994, the agreement required all three members to remove all tariffs among themselves over 15 years, but they were allowed to have their own tariff arrangements with nonmember countries. Cars and trucks must have 62.5% North American content to qualify for duty-free status. Transportation restrictions and other regulations have been being significantly reduced. A number of Asian and European corporations, such as Sweden's Electrolux, have built manufacturing facilities in Mexico to take advantage of the country's lower wages and easy access to the entire North American region.

South American countries are also working to harmonize their trading relationships with each other and to form trade associations. The establishment of the **Mercosur** (**Mercosul** in Portuguese) free-trade area among Argentina, Brazil, Uruguay, and Paraguay means that a manufacturing presence within these countries is becoming essential to avoid tariffs for nonmember countries. Venezuela has applied for admission to Mercosur. The **Andean Community** (Comunidad Andina de Naciones) is a free-trade alliance composed of Columbia, Ecuador, Peru, Bolivia, and Chile. On May 23, 2008, the **Union of South American Nations** was formed to unite the two existing free-trade areas with a secretariat in Ecuador and a parliament in Bolivia.

In 2004, the five Central American countries of El Salvador, Guatemala, Honduras, Nicaragua, and Costa Rica plus the United States signed the **Central American Free Trade Agreement (CAFTA)**. The Dominican Republic joined soon thereafter. Previously, Central American textile manufacturers had to pay import duties of 18%–28% to sell their clothes in the United States unless they bought their raw material from U.S. companies. Under CAFTA, members can buy raw material from anywhere and their exports are duty free. In addition, CAFTA eliminated import duties on 80% of U.S. goods exported to the region, with the remaining tariffs being phased out over 10 years.

The **Association of Southeast Asian Nations (ASEAN)**—composed of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam—is in the process of linking its members into a borderless economic zone by 2020. Tariffs had been significantly reduced among member countries by 2008. Increasingly referred to as ASEAN+3, ASEAN now includes China, Japan, and South Korea in its annual summit meetings. The ASEAN nations negotiated linkage of the ASEAN Free Trade Area (AFTA) with the existing free-trade area of Australia and New Zealand. With the EU extending eastward and NAFTA extending southward to someday connect with CAFTA and the Union of South American Nations, pressure is building on the independent Asian nations to join ASEAN.

imminent and 67% believed that such regulation would come between 2010 and 2015.[26] According to Eileen Claussen, President of the Pew Center on Global Climate Change:

> *There is a growing consensus among corporate leaders that taking action on climate change is a responsible business decision. From market shifts to regulatory constraints, climate change poses real risks and opportunities that companies must begin planning for today, or risk losing ground*

to their more forward-thinking competitors. Prudent steps taken now to address climate change can improve a company's competitive position relative to its peers and earn it a seat at the table to influence climate policy. With more and more action at the state level and increasing scientific clarity, it is time for businesses to craft corporate strategies that address climate change.[27]

Porter and Reinhardt warn that "in addition to understanding its emissions costs, every firm needs to evaluate its vulnerability to climate-related effects such as regional shifts in the availability of energy and water, the reliability of infrastructures and supply chains, and the prevalence of infectious diseases."[28] Swiss Re, the world's second-largest reinsurer, estimated that the overall economic costs of climate catastrophes related to climate change threatens to double to $150 billion per year by 2014. The insurance industry's share of this loss would be $30–$40 billion annually.[29]

The effects of climate change on industries and companies throughout the world can be grouped into six categories of risks: regulatory, supply chain, product and technology, litigation, reputational, and physical.[30]

1. **Regulatory Risk:** Companies in much of the world are already subject to the *Kyoto Protocol*, which requires the developed countries (and thus the companies operating within them) to reduce carbon dioxide and other greenhouse gases by an average of 6% from 1990 levels by 2012. The European Union has an emissions trading program that allows companies that emit greenhouse gases beyond a certain point to buy additional allowances from other companies whose emissions are lower than that allowed. Companies can also earn credits toward their emissions by investing in emissions abatement projects outside their own firms. Although the United States withdrew from the Kyoto Protocol, various regional, state, and local government policies affect company activities in the U.S. For example, seven Northeastern states, six Western states, and four Canadian provinces have adopted proposals to cap carbon emissions and establish carbon-trading programs.
2. **Supply Chain Risk:** Suppliers will be increasingly vulnerable to government regulations—leading to higher component and energy costs as they pass along increasing carbon-related costs to their customers. Global supply chains will be at risk from an increasing intensity of major storms and flooding. Higher sea levels resulting from the melting of polar ice will create problems for seaports. China, where much of the world's manufacturing is currently being outsourced, is becoming concerned with environmental degradation. In 2006, 12 Chinese ministries produced a report on global warming foreseeing a 5%–10% reduction in agricultural output by 2030; more droughts, floods, typhoons, and sandstorms; and a 40% increase in population threatened by plague.[31]

   The increasing scarcity of fossil-based fuel is already boosting transportation costs significantly. For example, Tesla Motors, the maker of an electric-powered sports car, transferred assembly of battery packs from Thailand to California because Thailand's low wages were more than offset by the costs of shipping thousand-pound battery packs across the Pacific Ocean.[32] Although the world production of oil had leveled off at 85 million barrels a day by 2008, the International Energy Agency predicted global demand to increase to 116 million barrels by 2030. Given that output from existing fields was falling 8% annually, oil companies must develop up to seven million barrels a day in additional capacity to meet projected demand. Nevertheless, James Mulva, CEO of ConocoPhilips, estimated in late 2007 that the output of oil will realistically stall at around 100 million barrels a day.[33]
3. **Product and Technology Risk:** Environmental sustainability can be a prerequisite to profitable growth. For example, worldwide investments in sustainable energy (including wind, solar, and water power) more than doubled to $70.9 billion from 2004 to 2006.[34] Sixty percent of U.S. respondents to an Environics study stated that knowing a company is mindful of its impact on the environment and society makes them more likely to buy their products

and services.[35] Carbon-friendly products using new technologies are becoming increasingly popular with consumers. Those automobile companies, for example, that were quick to introduce hybrid or alternative energy cars gained a competitive advantage.

4. **Litigation Risk:** Companies that generate significant carbon emissions face the threat of lawsuits similar to those in the tobacco, pharmaceutical, and building supplies (e.g., asbestos) industries. For example, oil and gas companies were sued for greenhouse gas emissions in the federal district court of Mississippi, based on the assertion that these companies contributed to the severity of Hurricane Katrina. As of October 2006, at least 16 cases were pending in federal or state courts in the U.S. "This boomlet in global warming litigation represents frustration with the White House's and Congress' failure to come to grips with the issue," explained John Echeverria, executive director of Georgetown University's Environmental Law & Policy Institute.[36]
5. **Reputational Risk:** A company's impact on the environment can heavily affect its overall reputation. The Carbon Trust, a consulting group, found that in some sectors the value of a company's brand could be at risk because of negative perceptions related to climate change. In contrast, a company with a good record of environmental sustainability may create a competitive advantage in terms of attracting and keeping loyal consumers, employees, and investors. For example, Wal-Mart's pursuit of environmental sustainability as a core business strategy has helped soften its negative reputation as a low-wage, low-benefit employer. By setting objectives for its retail stores of reducing greenhouse gases by 20%, reducing solid waste by 25%, increasing truck fleet efficiency by 25%, and using 100% renewable energy, it is also forcing its suppliers to become more environmentally sustainable.[37] Tools have recently been developed to measure sustainability on a variety of factors. For example, the SAM (Sustainable Asset Management) Group of Zurich, Switzerland, has been assessing and documenting the sustainability performance of over 1,000 corporations annually since 1999. SAM lists the top 15% of firms in its *Sustainability Yearbook* and classifies them into gold, silver, and bronze categories.[38] *Business Week* published its first list of the world's 100 most sustainable corporations January 29, 2007. The *Dow Jones Sustainability Indexes* and the *KLD Broad Market Social Index*, which evaluate companies on a range of environmental, social, and governance criteria are used for investment decisions.[39] Financial services firms, such as Goldman Sachs, Bank of America, JPMorgan Chase, and Citigroup have adopted guidelines for lending and asset management aimed at promoting clean-energy alternatives.[40]
6. **Physical Risk:** The direct risk posed by climate change includes the physical effects of droughts, floods, storms, and rising sea levels. Average Arctic temperatures have risen four to five degrees Fahrenheit (two to three degrees Celsius) in the past 50 years, leading to melting glaciers and sea levels rising one inch per decade.[41] Industries most likely to be affected are insurance, agriculture, fishing, forestry, real estate, and tourism. Physical risk can also affect other industries, such as oil and gas, through higher insurance premiums paid on facilities in vulnerable areas. Coca-Cola, for example, studies the linkages between climate change and water availability in terms of how this will affect the location of its new bottling plants. The warming of the Tibetan plateau has led to a thawing of the permafrost—thereby threatening the newly-completed railway line between China and Tibet.[42] (See the **Environmental Sustainability Issue** feature for a more complete list of projected effects of climate change.)

Although global warming remains a controversial topic, the best argument in favor of working toward environmental sustainability is a variation of Pascal's Wager on the existence of God:

> *The same goes for global warming. If you accept it as reality, adapting your strategy and practices, your plants will use less energy and emit fewer effluents. Your packaging will be more*

ENVIRONMENTAL sustainability issue

PROJECTED EFFECTS OF CLIMATE CHANGE

According to the Intergovernmental Panel on Climate Change (IPCC), the global climate system is projected to include a number of changes during the 21st century:

TEMPERATURE INCREASE

- Global average warming of approximately 0.2 degrees Celsius each decade.
- Long-term warming associated with doubled carbon dioxide concentrations in the range of 2 to 4.5 degrees Celsius.
- Fewer cold days and nights; warmer and more frequent hot days and nights.
- Increased frequency, intensity, and duration of heat waves in central Europe, western U.S., East Asia, and Korea.

SEA LEVEL RISE

- Sea level will continue to rise due to thermal expansion of seawater and loss of land ice at greater rates.
- Sea level rise of 18 to 59 centimeters by the end of the 21st century.
- Warming will continue contributing to sea level rise for many centuries even if greenhouse gas concentrations are stabilized.

PRECIPITATION AND HUMIDITY

- Increasing numbers of wet days in high latitudes; increasing numbers of dry spells in subtropical areas.
- Annual precipitation increases in most of northern Europe, Canada, northeastern U.S., and the Arctic.
- Winter precipitation increases in northern Asia and the Tibetan Plateau.
- Dry spells increase in length and frequency in the Mediterranean, Australia, and New Zealand; seasonal droughts increase in many mid-latitude continent interiors.

EXTREME WEATHER-RELATED EVENTS

- Increasing intense tropical cyclone activity.
- Increasing frequency of flash floods and large-area floods in many regions.
- Increasing risk of drought in Australia, eastern New Zealand, and the Mediterranean, with seasonal droughts in central Europe and Central America.
- Increasing wildfires in arid and semi-arid areas such as Australia and the western U.S.

OTHER RELATED EFFECTS

- Decreasing snow season length and depth in Europe and North America.
- Fewer cold days and nights leading to decreasing frosts.
- Accelerated glacier loss.
- Reduction in and warming of permafrost.

SOURCE: F. G. Sussman and J. R. Freed, "Adapting to Climate Change: A Business Approach," Paper prepared for the Pew Center on Global Climate Change (April 2008), pp. 5–6.

biodegradable, and your new products will be able to capture any markets created by severe weather effects. Yes, global warming might not be as damaging as some predict, and you might have invested more than you needed, but it's just as Pascal said: Given all the possible outcomes, the upside of being ready and prepared for a "fearsome event" surely beats the alternative.[43]

1.3 Theories of Organizational Adaptation

Globalization and environmental sustainability present real challenges to the strategic management of business corporations. How can any one company keep track of all the changing technological, economic, political–legal, and sociocultural trends around the world and make the necessary adjustments? This is not an easy task. Various theories have been proposed to account for how organizations obtain fit with their environment. The theory of **population ecology,** for

example, proposes that once an organization is successfully established in a particular environmental niche, it is unable to adapt to changing conditions. Inertia prevents the organization from changing. The company is thus replaced (is bought out or goes bankrupt) by other organizations more suited to the new environment. Although it is a popular theory in sociology, research fails to support the arguments of population ecology.[44] **Institution theory,** in contrast, proposes that organizations can and do adapt to changing conditions by imitating other successful organizations. To its credit, many examples can be found of companies that have adapted to changing circumstances by imitating an admired firm's strategies and management techniques.[45] The theory does not, however, explain how or by whom successful new strategies are developed in the first place. The **strategic choice perspective** goes one step further by proposing that not only do organizations adapt to a changing environment, but they also have the opportunity and power to reshape their environment. This perspective is supported by research indicating that the decisions of a firm's management have at least as great an impact on firm performance as overall industry factors.[46] Because of its emphasis on managers making rational strategic decisions, the strategic choice perspective is the dominant one taken in strategic management. Its argument that adaptation is a dynamic process fits with the view of **organizational learning theory,** which says that an organization adjusts defensively to a changing environment and uses knowledge offensively to improve the fit between itself and its environment. This perspective expands the strategic choice perspective to include people at all levels becoming involved in providing input into strategic decisions.[47]

In agreement with the concepts of organizational learning theory, an increasing number of companies are realizing that they must shift from a vertically organized, top-down type of organization to a more horizontally managed, interactive organization. They are attempting to adapt more quickly to changing conditions by becoming "learning organizations."

1.4 Creating a Learning Organization

Strategic management has now evolved to the point that its primary value is in helping an organization operate successfully in a dynamic, complex environment. To be competitive in dynamic environments, corporations are becoming less bureaucratic and more flexible. In stable environments such as those that existed in years past, a competitive strategy simply involved defining a competitive position and then defending it. As it takes less and less time for one product or technology to replace another, companies are finding that there is no such thing as a permanent competitive advantage. Many agree with Richard D'Aveni, who says in his book *Hypercompetition* that any sustainable competitive advantage lies not in doggedly following a centrally managed five-year plan but in stringing together a series of strategic short-term thrusts (as Intel does by cutting into the sales of its own offerings with periodic introductions of new products).[48] This means that corporations must develop *strategic flexibility*—the ability to shift from one dominant strategy to another.[49]

Strategic flexibility demands a long-term commitment to the development and nurturing of critical resources. It also demands that the company become a **learning organization**—an organization skilled at creating, acquiring, and transferring knowledge and at modifying its behavior to reflect new knowledge and insights. Organizational learning is a critical component of competitiveness in a dynamic environment. It is particularly important to innovation and new product development.[50] For example, both Hewlett-Packard and British Petroleum (BP) use an extensive network of informal committees to transfer knowledge among their cross-functional teams and to help spread new sources of knowledge quickly.[51] Siemens, a major electronics company, created a global knowledge-sharing network, called ShareNet, in order to quickly spread information technology throughout the firm. Based on its experience with ShareNet, Siemens established PeopleShareNet, a system that serves as a virtual expert marketplace for

facilitating the creation of cross-cultural teams composed of members with specific knowledge and competencies.[52]

Learning organizations are skilled at four main activities:

- Solving problems systematically
- Experimenting with new approaches
- Learning from their own experiences and past history as well as from the experiences of others
- Transferring knowledge quickly and efficiently throughout the organization[53]

Business historian Alfred Chandler proposes that high-technology industries are defined by "paths of learning" in which organizational strengths derive from learned capabilities.[54] According to Chandler, companies spring from an individual entrepreneur's knowledge, which then evolves into organizational knowledge. This organizational knowledge is composed of three basic strengths: technical skills, mainly in research; functional knowledge, such as production and marketing; and managerial expertise. This knowledge leads to new businesses where the company can succeed and creates an entry barrier to new competitors. Chandler points out that once a corporation has built its learning base to the point where it has become a core company in its industry, entrepreneurial startups are rarely able to successfully enter. Thus, organizational knowledge becomes a competitive advantage.

Strategic management is essential for learning organizations to avoid stagnation through continuous self-examination and experimentation. People at all levels, not just top management, participate in strategic management—helping to scan the environment for critical information, suggesting changes to strategies and programs to take advantage of environmental shifts, and working with others to continuously improve work methods, procedures, and evaluation techniques. For example, Motorola developed an action learning format in which people from marketing, product development, and manufacturing meet to argue and reach agreement about the needs of the market, the best new product, and the schedules of each group producing it. This action learning approach overcame the problems that arose previously when the three departments met and formally agreed on plans but continued with their work as if nothing had happened.[55] Research indicates that involving more people in the strategy process results in people not only viewing the process more positively, but also acting in ways that make the process more effective.[56]

Organizations that are willing to experiment and are able to learn from their experiences are more successful than those that are not.[57] For example, in a study of U.S. manufacturers of diagnostic imaging equipment, the most successful firms were those that improved products sold in the United States by incorporating some of what they had learned from their manufacturing and sales experiences in other nations. The less successful firms used the foreign operations primarily as sales outlets, not as important sources of technical knowledge.[58] Research also reveals that multidivisional corporations that establish ways to transfer knowledge across divisions are more innovative than other diversified corporations that do not.[59]

1.5 Basic Model of Strategic Management

Strategic management consists of four basic elements:

- **Environmental scanning**
- **Strategy formulation**
- **Strategy implementation**
- **Evaluation and control**

FIGURE 1–1
Basic Elements of the Strategic Management Process

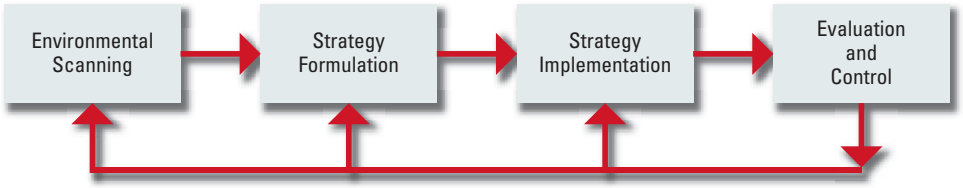
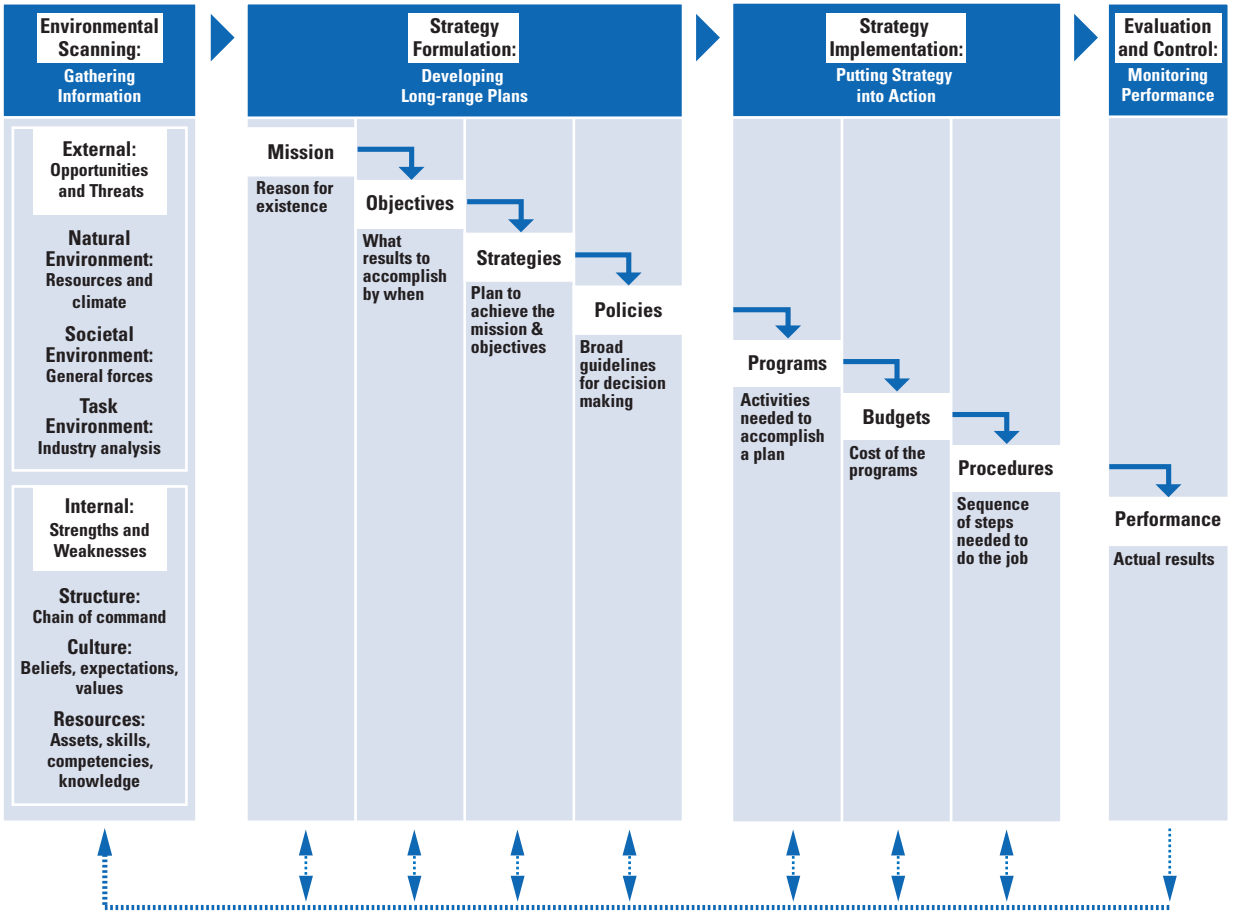


Figure 1–1 illustrates how these four elements interact; **Figure 1–2** expands each of these elements and serves as the model for this book. This model is both rational and prescriptive. It is a planning model that presents what a corporation *should* do in terms of the strategic management process, not what any particular firm may actually do. The rational planning model predicts that as environmental uncertainty increases, corporations that work more diligently to analyze and predict more accurately the changing situation in which they operate will outperform those that do not. Empirical research studies support this model.[60] The terms used in Figure 1–2 are explained in the following pages.

FIGURE 1–2 Strategic Management Model



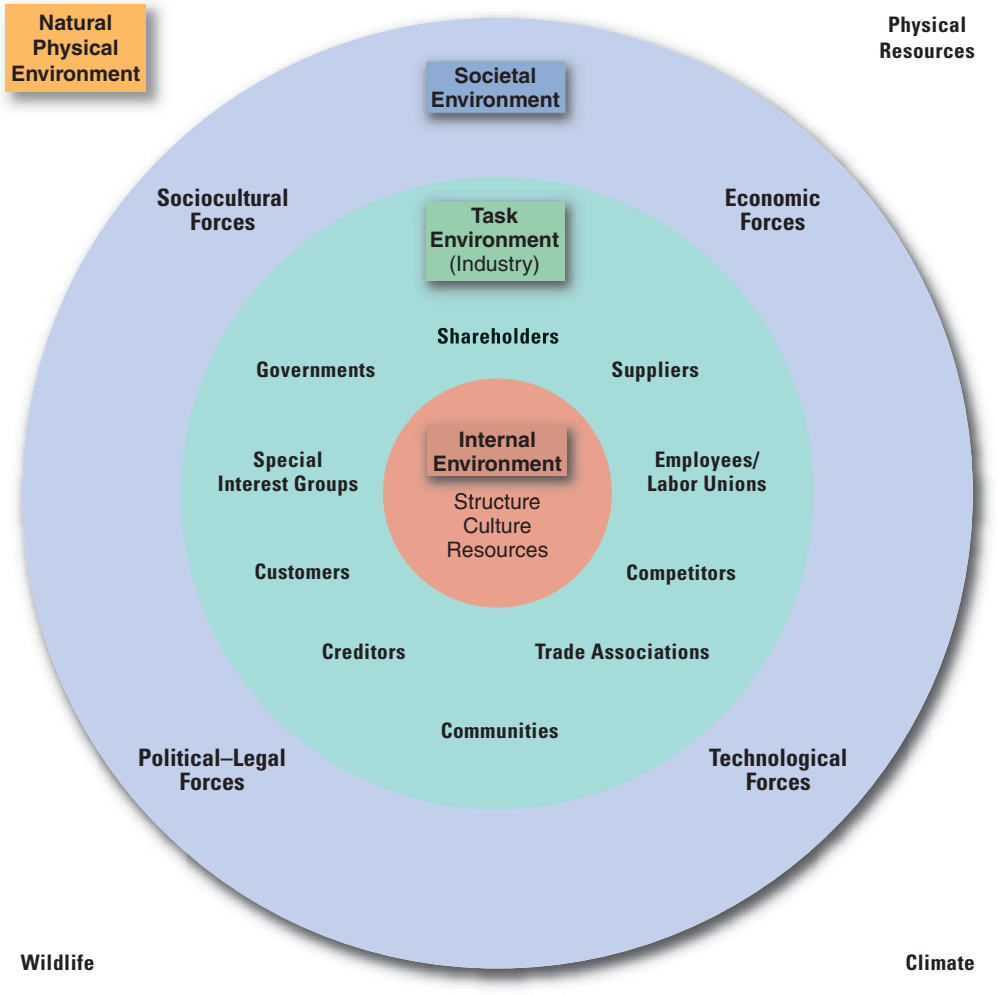
SOURCE: T. L. Wheelen, "Strategic Management Model," adapted from "Concepts of Management," presented to Society for Advancement of Management (SAM), International Meeting, Richmond, VA, 1981. T.L. Wheelen and SAM. Copyright © 1982, 1985, 1988, and 2005 by T.L. Wheelen and J.D. Hunger. Revised 1989, 1995, 1998, 2000 and 2005. Reprinted with permission.

ENVIRONMENTAL SCANNING

Environmental scanning is the monitoring, evaluating, and disseminating of information from the external and internal environments to key people within the corporation. Its purpose is to identify **strategic factors**—those external and internal elements that will determine the future of the corporation. The simplest way to conduct environmental scanning is through **SWOT analysis**. SWOT is an acronym used to describe the particular **S**trengths, **W**eaknesses, **O**pportunities, and **T**hreats that are strategic factors for a specific company. The **external environment** consists of variables (**O**pportunities and **T**hreats) that are outside the organization and not typically within the short-run control of top management. These variables form the context within which the corporation exists. **Figure 1–3** depicts key environmental variables. They may be general forces and trends within the natural or societal environments or specific factors that operate within an organization's specific task environment—often called its *industry*. (These external variables are defined and discussed in more detail in **Chapter 4**.)

The **internal environment** of a corporation consists of variables (**S**trengths and **W**eaknesses) that are within the organization itself and are not usually within the short-run

FIGURE 1–3 Environmental Variables



control of top management. These variables form the context in which work is done. They include the corporation's structure, culture, and resources. Key strengths form a set of core competencies that the corporation can use to gain competitive advantage. (These internal variables and core competencies are defined and discussed in more detail in **Chapter 5**.)

STRATEGY FORMULATION

Strategy formulation is the development of long-range plans for the effective management of environmental opportunities and threats, in light of corporate strengths and weaknesses (SWOT). It includes defining the corporate mission, specifying achievable objectives, developing strategies, and setting policy guidelines.

Mission

An organization's **mission** is the purpose or reason for the organization's existence. It tells what the company is providing to society—either a service such as housecleaning or a product such as automobiles. A well-conceived mission statement defines the fundamental, unique purpose that sets a company apart from other firms of its type and identifies the scope or domain of the company's operations in terms of products (including services) offered and markets served. Research reveals that firms with mission statements containing explicit descriptions of customers served and technologies used have significantly higher growth than firms without such statements.[61] A mission statement may also include the firm's values and philosophy about how it does business and treats its employees. It puts into words not only what the company is now but what it wants to become—management's strategic vision of the firm's future. The mission statement promotes a sense of shared expectations in employees and communicates a public image to important stakeholder groups in the company's task environment. Some people like to consider vision and mission as two different concepts: Mission describes what the organization is now; **vision** describes what the organization would like to become. We prefer to combine these ideas into a single mission statement.[62] Some companies prefer to list their values and philosophy of doing business in a separate publication called a *values statement.* For a listing of the many things that could go into a mission statement, see **Strategy Highlight 1.1**.

One example of a mission statement is that of Google:

> *To organize the world's information and make it universally accessible and useful.*[63]

Another classic example is that etched in bronze at Newport News Shipbuilding, unchanged since its founding in 1886:

> *We shall build good ships here—at a profit if we can—at a loss if we must—but always good ships.*[64]

A mission may be defined narrowly or broadly in scope. An example of a *broad* mission statement is that used by many corporations: "Serve the best interests of shareowners, customers, and employees." A broadly defined mission statement such as this keeps the company from restricting itself to one field or product line, but it fails to clearly identify either what it makes or which products/markets it plans to emphasize. Because this broad statement is so general, a *narrow* mission statement, such as the preceding examples by Google and Newport News Shipbuilding, is generally more useful. A narrow mission very clearly states the organization's primary business, but it may limit the scope of the firm's activities in terms of the product or service offered, the technology used, and the market served. Research indicates that a narrow mission statement may be best in a turbulent industry because it keeps the firm focused on what it does best; whereas, a broad mission statement may be best in a stable environment that lacks growth opportunities.[65]

STRATEGY highlight 1.1

DO YOU HAVE A GOOD MISSION STATEMENT?

Andrew Campbell, a director of Ashridge Strategic Management Centre and a long-time contributor to *Long Range Planning*, proposes a means for evaluating a mission statement. Arguing that mission statements can be more than just an expression of a company's purpose and ambition, he suggests that they can also be a company flag to rally around, a signpost for all stakeholders, a guide to behavior, and a celebration of a company's culture. For a company trying to achieve all of the above, evaluate its mission statement using the following 10-question test. Score each question 0 for no, 1 for somewhat, or 2 for yes. According to Campbell, a score of over 15 is exceptional, and a score of less than 10 suggests that more work needs to be done.

1. Does the statement describe an inspiring purpose that avoids playing to the selfish interests of the stakeholders?
2. Does the statement describe the company's responsibility to its stakeholders?
3. Does the statement define a business domain and explain why it is attractive?
4. Does the statement describe the strategic positioning that the company prefers in a way that helps to identify the sort of competitive advantage it will look for?
5. Does the statement identify values that link with the organization's purpose and act as beliefs with which employees can feel proud?
6. Do the values resonate with and reinforce the organization's strategy?
7. Does the statement describe important behavior standards that serve as beacons of the strategy and the values?
8. Are the behavior standards described in a way that enables individual employees to judge whether they are behaving correctly?
9. Does the statement give a portrait of the company, capturing the culture of the organization?
10. Is the statement easy to read?

SOURCE: Reprinted from Long Range Planning, Vol. 30, No. 6, 1997, Campbell "Mission Statements", pp. 931–932, Copyright © 1997 with permission of Elsevier.

Objectives

Objectives are the end results of planned activity. They should be stated as *action verbs* and tell what is to be accomplished by when and quantified if possible. The achievement of corporate objectives should result in the fulfillment of a corporation's mission. In effect, this is what society gives back to the corporation when the corporation does a good job of fulfilling its mission. For example, by providing society with gums, candy, iced tea, and carbonated drinks, Cadbury Schweppes, has become the world's largest confectioner by sales. One of its prime objectives is to increase sales 4%–6% each year. Even though its profit margins were lower than those of Nestlé, Kraft, and Wrigley, its rivals in confectionary, or those of Coca-Cola or Pepsi, its rivals in soft drinks, Cadbury Schweppes' management established the objective of increasing profit margins from around 10% in 2007 to the mid-teens by 2011.[66]

The term *goal* is often used interchangeably with the term objective. In this book, we prefer to differentiate the two terms. In contrast to an objective, we consider a *goal* as an open-ended statement of what one wants to accomplish, with no quantification of what is to be achieved and no time criteria for completion. For example, a simple statement of "increased profitability" is thus a goal, not an objective, because it does not state how much profit the firm wants to make the next year. A good objective should be action-oriented and begin with the word *to*. An example of an objective is "to increase the firm's profitability in 2010 by 10% over 2009."

Some of the areas in which a corporation might establish its goals and objectives are:

- Profitability (net profits)
- Efficiency (low costs, etc.)
- Growth (increase in total assets, sales, etc.)
- Shareholder wealth (dividends plus stock price appreciation)
- Utilization of resources (ROE or ROI)
- Reputation (being considered a "top" firm)
- Contributions to employees (employment security, wages, diversity)
- Contributions to society (taxes paid, participation in charities, providing a needed product or service)
- Market leadership (market share)
- Technological leadership (innovations, creativity)
- Survival (avoiding bankruptcy)
- Personal needs of top management (using the firm for personal purposes, such as providing jobs for relatives)

Strategies

A **strategy** of a corporation forms a comprehensive master plan that states how the corporation will achieve its mission and objectives. It maximizes competitive advantage and minimizes competitive disadvantage. For example, even though Cadbury Schweppes was a major competitor in confectionary and soft drinks, it was not likely to achieve its challenging objective of significantly increasing its profit margin within four years without making a major change in strategy. Management therefore decided to cut costs by closing 33 factories and reducing staff by 10%. It also made the strategic decision to concentrate on the confectionary business by divesting its less-profitable Dr. Pepper/Snapple soft drinks unit. Management was also considering acquisitions as a means of building on its existing strengths in confectionary by purchasing either Kraft's confectionary unit or the Hershey Company.

The typical business firm usually considers three types of strategy: corporate, business, and functional.

1. **Corporate strategy** describes a company's overall direction in terms of its general attitude toward growth and the management of its various businesses and product lines. Corporate strategies typically fit within the three main categories of stability, growth, and retrenchment. Cadbury Schweppes, for example, was following a corporate strategy of retrenchment by selling its marginally profitable soft drink business and concentrating on its very successful confectionary business.
2. **Business strategy** usually occurs at the business unit or product level, and it emphasizes improvement of the competitive position of a corporation's products or services in the specific industry or market segment served by that business unit. Business strategies may fit within the two overall categories, *competitive* and *cooperative* strategies. For example, Staples, the U.S. office supply store chain, has used a competitive strategy to differentiate its retail stores from its competitors by adding services to its stores, such as copying, UPS shipping, and hiring mobile technicians who can fix computers and install networks. British Airways has followed a cooperative strategy by forming an alliance with American Airlines in order to provide global service. Cooperative strategy may thus be used to

provide a competitive advantage. Intel, a manufacturer of computer microprocessors, uses its alliance (cooperative strategy) with Microsoft to differentiate itself (competitive strategy) from AMD, its primary competitor.

3. **Functional strategy** is the approach taken by a functional area to achieve corporate and business unit objectives and strategies by maximizing resource productivity. It is concerned with developing and nurturing a distinctive competence to provide a company or business unit with a competitive advantage. Examples of research and development (R&D) functional strategies are technological followership (imitation of the products of other companies) and technological leadership (pioneering an innovation). For years, Magic Chef had been a successful appliance maker by spending little on R&D but by quickly imitating the innovations of other competitors. This helped the company to keep its costs lower than those of its competitors and consequently to compete with lower prices. In terms of marketing functional strategies, Procter & Gamble (P&G) is a master of marketing "pull"—the process of spending huge amounts on advertising in order to create customer demand. This supports P&G's competitive strategy of differentiating its products from those of its competitors.

Business firms use all three types of strategy simultaneously. A **hierarchy of strategy** is a grouping of strategy types by level in the organization. Hierarchy of strategy is a nesting of one strategy within another so that they complement and support one another. (See **Figure 1–4**.) Functional strategies support business strategies, which, in turn, support the corporate strategy(ies).

Just as many firms often have no formally stated objectives, many firms have unstated, incremental, or intuitive strategies that have never been articulated or analyzed. Often the only way to spot a corporation's implicit strategies is to look not at what management says but at what it does. Implicit strategies can be derived from corporate policies, programs approved (and disapproved), and authorized budgets. Programs and divisions favored by budget increases and staffed by managers who are considered to be on the fast promotion track reveal where the corporation is putting its money and its energy.

FIGURE 1–4
Hierarchy of Strategy

Policies

A **policy** is a broad guideline for decision making that links the formulation of a strategy with its implementation. Companies use policies to make sure that employees throughout the firm make decisions and take actions that support the corporation's mission, objectives, and strategies. For example, when Cisco decided on a strategy of growth through acquisitions, it established a policy to consider only companies with no more than 75 employees, 75% of whom were engineers.[67] Consider the following company policies:

- **3M:** 3M says researchers should spend 15% of their time working on something other than their primary project. (This supports 3M's strong product development strategy.)
- **Intel:** Intel cannibalizes its own product line (undercuts the sales of its current products) with better products before a competitor does so. (This supports Intel's objective of market leadership.)
- **General Electric:** GE must be number one or two wherever it competes. (This supports GE's objective to be number one in market capitalization.)
- **Southwest Airlines:** Southwest offers no meals or reserved seating on airplanes. (This supports Southwest's competitive strategy of having the lowest costs in the industry.)
- **Exxon:** Exxon pursues only projects that will be profitable even when the price of oil drops to a low level. (This supports Exxon's profitability objective.)

Policies such as these provide clear guidance to managers throughout the organization. (Strategy formulation is discussed in greater detail in **Chapters 6, 7,** and **8**.)

STRATEGY IMPLEMENTATION

Strategy implementation is a process by which strategies and policies are put into action through the development of programs, budgets, and procedures. This process might involve changes within the overall culture, structure, and/or management system of the entire organization. Except when such drastic corporatewide changes are needed, however, the implementation of strategy is typically conducted by middle- and lower-level managers, with review by top management. Sometimes referred to as *operational planning*, strategy implementation often involves day-to-day decisions in resource allocation.

Programs

A **program** is a statement of the activities or steps needed to accomplish a single-use plan. It makes a strategy action oriented. It may involve restructuring the corporation, changing the company's internal culture, or beginning a new research effort. For example, Boeing's strategy to regain industry leadership with its proposed 787 Dreamliner meant that the company had to increase its manufacturing efficiency in order to keep the price low. To significantly cut costs, management decided to implement a series of programs:

- Outsource approximately 70% of manufacturing.
- Reduce final assembly time to three days (compared to 20 for its 737 plane) by having suppliers build completed plane sections.
- Use new, lightweight composite materials in place of aluminum to reduce inspection time.
- Resolve poor relations with labor unions caused by downsizing and outsourcing.

Another example is a set of programs used by automaker BMW to achieve its objective of increasing production efficiency by 5% each year: (a) shorten new model development time from 60 to 30 months, (b) reduce preproduction time from a year to no more than five months,

and (c) build at least two vehicles in each plant so that production can shift among models depending upon demand.

Budgets

A **budget** is a statement of a corporation's programs in terms of dollars. Used in planning and control, a budget lists the detailed cost of each program. Many corporations demand a certain percentage return on investment, often called a "hurdle rate," before management will approve a new program. This ensures that the new program will significantly add to the corporation's profit performance and thus build shareholder value. The budget thus not only serves as a detailed plan of the new strategy in action, it also specifies through pro forma financial statements the expected impact on the firm's financial future.

For example, General Motors budgeted $4.3 billion to update and expand its Cadillac line of automobiles. With this money, the company was able to increase the number of models from five to nine and to offer more powerful engines, sportier handling, and edgier styling. The company reversed its declining market share by appealing to a younger market. (The average Cadillac buyer in 2000 was 67 years old.)[68] Another example is the $8 billion budget that General Electric established to invest in new jet engine technology for regional-jet airplanes. Management decided that an anticipated growth in regional jets should be the company's target market. The program paid off when GE won a $3 billion contract to provide jet engines for China's new fleet of 500 regional jets in time for the 2008 Beijing Olympics.[69]

Procedures

Procedures, sometimes termed Standard Operating Procedures (SOP), are a system of sequential steps or techniques that describe in detail how a particular task or job is to be done. They typically detail the various activities that must be carried out in order to complete the corporation's program. For example, when the home improvement retailer Home Depot noted that sales were lagging because its stores were full of clogged aisles, long checkout times, and too few salespeople, management changed its procedures for restocking shelves and pricing the products. Instead of requiring its employees to do these activities at the same time they were working with customers, management moved these activities to when the stores were closed at night. Employees were then able to focus on increasing customer sales during the day. Both UPS and FedEx put such an emphasis on consistent, quality service that both companies have strict rules for employee behavior, ranging from how a driver dresses to how keys are held when approaching a customer's door. (Strategy implementation is discussed in more detail in **Chapters 9** and **10**.)

EVALUATION AND CONTROL

Evaluation and control is a process in which corporate activities and performance results are monitored so that actual performance can be compared with desired performance. Managers at all levels use the resulting information to take corrective action and resolve problems. Although evaluation and control is the final major element of strategic management, it can also pinpoint weaknesses in previously implemented strategic plans and thus stimulate the entire process to begin again.

Performance is the end result of activities.[70] It includes the actual outcomes of the strategic management process. The practice of strategic management is justified in terms of its ability to improve an organization's performance, typically measured in terms of profits and return on investment. For evaluation and control to be effective, managers must obtain clear, prompt, and unbiased information from the people below them in the corporation's hierarchy. Using

this information, managers compare what is actually happening with what was originally planned in the formulation stage.

For example, when market share (followed by profits) declined at Dell in 2007, Michael Dell, founder, returned to the CEO position and reevaluated his company's strategy and operations. Planning for continued growth, the company's expansion of its computer product line into new types of hardware, such as storage, printers, and televisions, had not worked as planned. In some areas, like televisions and printers, Dell's customization ability did not add much value. In other areas, like services, lower-cost competitors were already established. Michael Dell concluded, "I think you're going to see a more streamlined organization, with a much clearer strategy."[71]

The evaluation and control of performance completes the strategic management model. Based on performance results, management may need to make adjustments in its strategy formulation, in implementation, or in both. (Evaluation and control is discussed in more detail in **Chapter 11**.)

FEEDBACK/LEARNING PROCESS

Note that the strategic management model depicted in **Figure 1–2** includes a feedback/learning process. Arrows are drawn coming out of each part of the model and taking information to each of the previous parts of the model. As a firm or business unit develops strategies, programs, and the like, it often must go back to revise or correct decisions made earlier in the process. For example, poor performance (as measured in evaluation and control) usually indicates that something has gone wrong with either strategy formulation or implementation. It could also mean that a key variable, such as a new competitor, was ignored during environmental scanning and assessment. In the case of Dell, the personal computer market had matured and by 2007 there were fewer growth opportunities available within the industry. Even Jim Cramer, host of the popular television program, *Mad Money*, was referring to computers in 2008 as "old technology" having few growth prospects. Dell's management needed to reassess the company's environment and find better opportunities to profitably apply its core competencies.

1.6 Initiation of Strategy: Triggering Events

After much research, Henry Mintzberg discovered that strategy formulation is typically not a regular, continuous process: "It is most often an irregular, discontinuous process, proceeding in fits and starts. There are periods of stability in strategy development, but also there are periods of flux, of groping, of piecemeal change, and of global change."[72] This view of strategy formulation as an irregular process can be explained by the very human tendency to continue on a particular course of action until something goes wrong or a person is forced to question his or her actions. This period of strategic drift may result from inertia on the part of the organization, or it may reflect management's belief that the current strategy is still appropriate and needs only some fine-tuning.

Most large organizations tend to follow a particular strategic orientation for about 15 to 20 years before making a significant change in direction.[73] This phenomenon, called *punctuated equilibrium,* describes corporations as evolving through relatively long periods of stability (equilibrium periods) punctuated by relatively short bursts of fundamental change (revolutionary periods).[74] After this rather long period of fine-tuning an existing strategy, some sort of shock to the system is needed to motivate management to seriously reassess the corporation's situation.

A **triggering event** is something that acts as a stimulus for a change in strategy. Some possible triggering events are:[75]

- **New CEO:** By asking a series of embarrassing questions, a new CEO cuts through the veil of complacency and forces people to question the very reason for the corporation's existence.
- **External intervention:** A firm's bank suddenly refuses to approve a new loan or suddenly demands payment in full on an old one. A key customer complains about a serious product defect.
- **Threat of a change in ownership:** Another firm may initiate a takeover by buying a company's common stock.
- **Performance gap:** A *performance gap* exists when performance does not meet expectations. Sales and profits either are no longer increasing or may even be falling.
- **Strategic inflection point:** Coined by Andy Grove, past-CEO of Intel Corporation, a *strategic inflection point* is what happens to a business when a major change takes place due to the introduction of new technologies, a different regulatory environment, a change in customers' values, or a change in what customers prefer.[76]

Unilever is an example of one company in which a triggering event forced management to radically rethink what it was doing. See **Strategy Highlight 1.2** to learn how a slumping stock price stimulated a change in strategy at Unilever.

STRATEGY highlight 1.2

TRIGGERING EVENT AT UNILEVER

Unilever, the world's second-largest consumer goods company, received a jolt in 2004 when its stock price fell sharply after management had warned investors that profits would be lower than anticipated. Even though the company had been the first consumer goods company to enter the world's emerging economies in Africa, China, India, and Latin America with a formidable range of products and local knowledge, its sales faltered when rivals began to attack its entrenched position in these markets. Procter & Gamble's (P&G) acquisition of Gillette had greatly bolstered P&G's growing portfolio of global brands and allowed it to undermine Unilever's global market share. For example, when P&G targeted India for a sales initiative in 2003–04, profit margins fell at Unilever's Indian subsidiary from 20% to 13%.

An in-depth review of Unilever's brands revealed that its brands were doing as well as were those of its rivals. Something else was wrong. According to Richard Rivers, Unilever's head of corporate strategy, "We were just not executing as well as we should have."

Unilever's management realized that it had no choice but to make-over the company from top to bottom. Over decades of operating in almost every country in the world, the company had become fat with unnecessary bureaucracy and complexity. Unilever's traditional emphasis on the autonomy of its country managers had led to a lack of synergy and a duplication of corporate structures. Country managers had been making strategic decisions without regard for their effect on other regions or on the corporation as a whole. Starting at the top, two joint chairmen were replaced by one sole chief executive. In China, three companies with three chief executives were replaced by one company with one person in charge. Overall staff was cut from 223,000 in 2004 to 179,000 in 2008. By 2010, management planned close to 50 of its 300 factories and to eliminate 75 of 100 regional centers. Twenty thousand more jobs were selected to be eliminated over a four-year period. Ralph Kugler, manager of Unilever's home and personal care division, exhibited confidence that after these changes, the company was better prepared to face competition. "We are much better organized now to defend ourselves," he stated.

SOURCE: Summarized from "The Legacy that Got Left on the Shelf," *The Economist* (February 2, 2008), pp. 77–79.

1.7 Strategic Decision Making

The distinguishing characteristic of strategic management is its emphasis on strategic decision making. As organizations grow larger and more complex, with more uncertain environments, decisions become increasingly complicated and difficult to make. In agreement with the strategic choice perspective mentioned earlier, this book proposes a strategic decision-making framework that can help people make these decisions regardless of their level and function in the corporation.

WHAT MAKES A DECISION STRATEGIC

Unlike many other decisions, **strategic decisions** deal with the long-run future of an entire organization and have three characteristics:

1. **Rare:** Strategic decisions are unusual and typically have no precedent to follow.
2. **Consequential:** Strategic decisions commit substantial resources and demand a great deal of commitment from people at all levels.
3. **Directive:** Strategic decisions set precedents for lesser decisions and future actions throughout an organization.[77]

One example of a strategic decision with all of these characteristics was that made by Genentech, a biotechnology company that had been founded in 1976 to produce protein-based drugs from cloned genes. After building sales to $9 billion and profits to $2 billion in 2006, the company's sales growth slowed and its stock price dropped in 2007. The company's products were reaching maturity with few new ones in the pipeline. To regain revenue growth, management decided to target autoimmune diseases, such as multiple sclerosis, rheumatoid arthritis, lupus, and 80 other ailments for which there was no known lasting treatment. This was an enormous opportunity, but also a very large risk for the company. Existing drugs in this area either weren't effective for many patients or caused side effects that were worse than the disease. Competition from companies like Amgen and Novartis were already vying for leadership in this area. A number of Genentech's first attempts in the area had failed to do well against the competition.

The strategic decision to commit resources to this new area was based on a report from a British physician that the Genentech's cancer drug Rituxan eased the agony of rheumatoid arthritis in five of his patients. CEO Arthur Levinson was so impressed with this report that he immediately informed Genentech's board of directors. He urged them to support a full research program for Rituxan in autoimmune disease. With the board's blessing, Levinson launched a program to study the drug as a treatment for rheumatoid arthritis, MS, and lupus. The company deployed a third of its 1,000 researchers to pursue new drugs to fight autoimmune diseases. In 2006, Rituxan was approved to treat rheumatoid arthritis and captured 10% of the market. The company was working on some completely new approaches to autoimmune disease. The research mandate was to consider ideas others might overlook. "There's this tremendous herd instinct out there," said Levinson. "That's a great opportunity, because often the crowd is wrong."[78]

MINTZBERG'S MODES OF STRATEGIC DECISION MAKING

Some strategic decisions are made in a flash by one person (often an entrepreneur or a powerful chief executive officer) who has a brilliant insight and is quickly able to convince others to adopt his or her idea. Other strategic decisions seem to develop out of a series of small incremental choices that over time push an organization more in one direction than another.

According to Henry Mintzberg, the three most typical approaches, or modes, of strategic decision making are entrepreneurial, adaptive, and planning (a fourth mode, logical incrementalism, was added later by Quinn):[79]

- **Entrepreneurial mode:** Strategy is made by one powerful individual. The focus is on opportunities; problems are secondary. Strategy is guided by the founder's own vision of direction and is exemplified by large, bold decisions. The dominant goal is growth of the corporation. Amazon.com, founded by Jeff Bezos, is an example of this mode of strategic decision making. The company reflected Bezos' vision of using the Internet to market books and more. Although Amazon's clear growth strategy was certainly an advantage of the entrepreneurial mode, Bezos' eccentric management style made it difficult to retain senior executives.[80]
- **Adaptive mode:** Sometimes referred to as "muddling through," this decision-making mode is characterized by reactive solutions to existing problems, rather than a proactive search for new opportunities. Much bargaining goes on concerning priorities of objectives. Strategy is fragmented and is developed to move a corporation forward incrementally. This mode is typical of most universities, many large hospitals, a large number of governmental agencies, and a surprising number of large corporations. Encyclopaedia Britannica Inc., operated successfully for many years in this mode, but it continued to rely on the door-to-door selling of its prestigious books long after dual-career couples made that marketing approach obsolete. Only after it was acquired in 1996 did the company change its door-to-door sales to television advertising and Internet marketing. The company now charges libraries and individual subscribers for complete access to Brittanica.com and offers CD-ROMs in addition to a small number of its 32-volume print set.[81]
- **Planning mode:** This decision-making mode involves the systematic gathering of appropriate information for situation analysis, the generation of feasible alternative strategies, and the rational selection of the most appropriate strategy. It includes both the proactive search for new opportunities and the reactive solution of existing problems. IBM under CEO Louis Gerstner is an example of the planning mode. When Gerstner accepted the position of CEO in 1993, he realized that IBM was in serious difficulty. Mainframe computers, the company's primary product line, were suffering a rapid decline both in sales and market share. One of Gerstner's first actions was to convene a two-day meeting on corporate strategy with senior executives. An in-depth analysis of IBM's product lines revealed that the only part of the company that was growing was services, but it was a relatively small segment and not very profitable. Rather than focusing on making and selling its own computer hardware, IBM made the strategic decision to invest in services that integrated information technology. IBM thus decided to provide a complete set of services from building systems to defining architecture to actually running and managing the computers for the customer—regardless of who made the products. Because it was no longer important that the company be completely vertically integrated, it sold off its DRAM, disk-drive, and laptop computer businesses and exited software application development. Since making this strategic decision in 1993, 80% of IBM's revenue growth has come from services.[82]
- **Logical incrementalism:** A fourth decision-making mode can be viewed as a synthesis of the planning, adaptive, and, to a lesser extent, the entrepreneurial modes. In this mode,

top management has a reasonably clear idea of the corporation's mission and objectives, but, in its development of strategies, it chooses to use "an interactive process in which the organization probes the future, experiments and learns from a series of partial (incremental) commitments rather than through global formulations of total strategies."[83] Thus, although the mission and objectives are set, the strategy is allowed to emerge out of debate, discussion, and experimentation. This approach appears to be useful when the environment is changing rapidly and when it is important to build consensus and develop needed resources before committing an entire corporation to a specific strategy. In his analysis of the petroleum industry, Grant described strategic planning in this industry as "planned emergence." Corporate headquarters established the mission and objectives but allowed the business units to propose strategies to achieve them.[84]

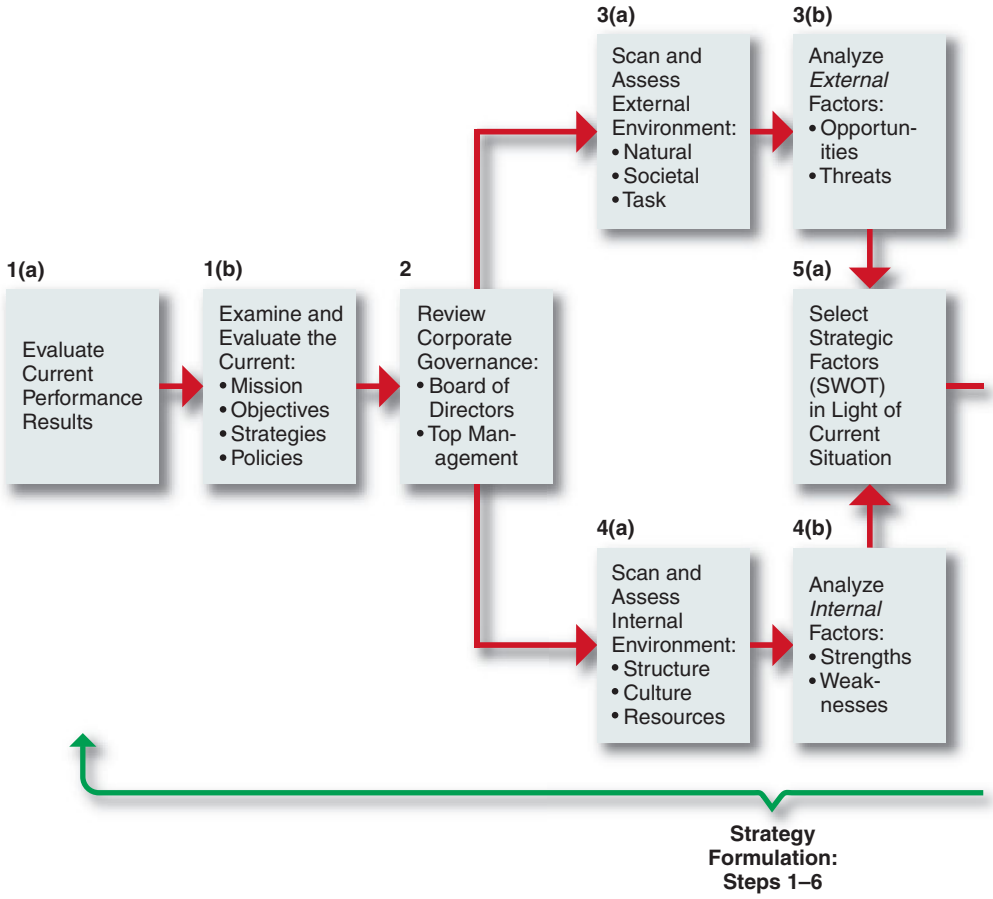
STRATEGIC DECISION-MAKING PROCESS: AID TO BETTER DECISIONS

Good arguments can be made for using either the entrepreneurial or adaptive modes (or logical incrementalism) in certain situations.[85] This book proposes, however, that in most situations the planning mode, which includes the basic elements of the strategic management process, is a more rational and thus better way of making strategic decisions. Research indicates that the planning mode is not only more analytical and less political than are the other modes, but it is also more appropriate for dealing with complex, changing environments.[86] We therefore propose the following eight-step **strategic decision-making process** to improve the making of strategic decisions (see **Figure 1–5**):

1. **Evaluate current performance results** in terms of (a) return on investment, profitability, and so forth, and (b) the current mission, objectives, strategies, and policies.
2. **Review corporate governance**—that is, the performance of the firm's board of directors and top management.
3. **Scan and assess the external environment** to determine the strategic factors that pose **O**pportunities and **T**hreats.
4. **Scan and assess the internal corporate environment** to determine the strategic factors that are **S**trengths (especially core competencies) and **W**eaknesses.
5. **Analyze strategic (SWOT) factors** to (a) pinpoint problem areas and (b) review and revise the corporate mission and objectives, as necessary.
6. **Generate, evaluate, and select the best alternative strategy** in light of the analysis conducted in step 5.
7. **Implement selected strategies** via programs, budgets, and procedures.
8. **Evaluate implemented strategies** via feedback systems, and the control of activities to ensure their minimum deviation from plans.

This rational approach to strategic decision making has been used successfully by corporations such as Warner-Lambert, Target, General Electric, IBM, Avon Products, Bechtel Group Inc., and Taisei Corporation.

FIGURE 1–5
Strategic Decision-Making Process

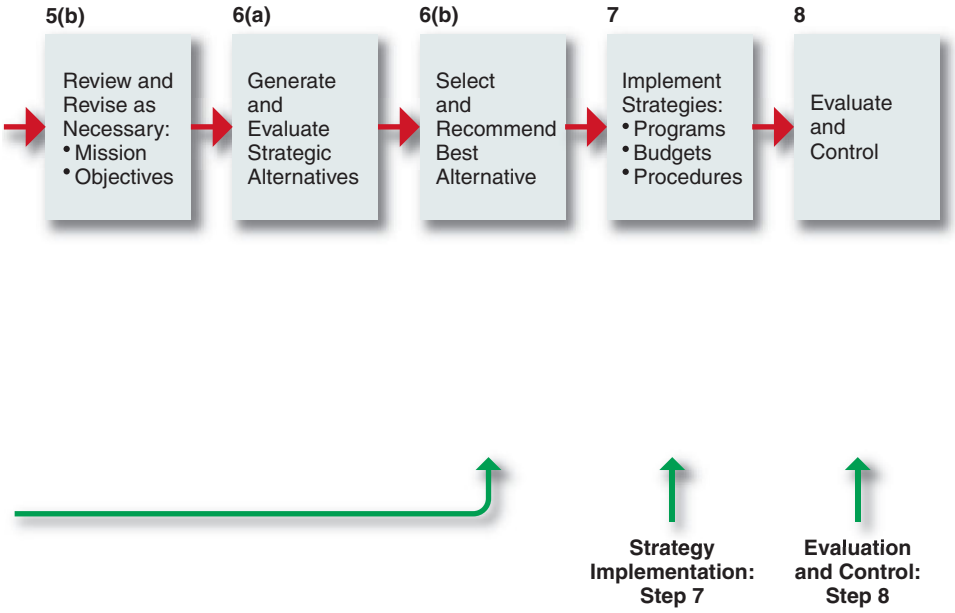


SOURCE: T. L. Wheelen and J. D. Hunger, *Strategic Decision-Making Process*. Copyright © 1994 and 1997 by Wheelen & Hunger Associates. Reprinted by permission.

1.8 The Strategic Audit: Aid to Strategic Decision-Making

The strategic decision-making process is put into action through a technique known as the strategic audit. A **strategic audit** provides a checklist of questions, by area or issue, that enables a systematic analysis to be made of various corporate functions and activities. (See **Appendix 1.A** at the end of this chapter.) Note that the numbered primary headings in the audit are the same as the numbered blocks in the strategic decision-making process in **Figure 1–5**. Beginning with an evaluation of current performance, the audit continues with environmental scanning, strategy formulation, and strategy implementation, and it concludes with evaluation and control. A strategic audit is a type of management audit and is extremely useful as a diagnostic tool to pinpoint corporatewide problem areas and to highlight organizational strengths and weaknesses.[87] A strategic audit can help determine why a certain area is creating problems for a corporation and help generate solutions to the problem.

A strategic audit is not an all-inclusive list, but it presents many of the critical questions needed for a detailed strategic analysis of any business corporation. Some questions or even some areas might be inappropriate for a particular company; in other cases, the questions may



be insufficient for a complete analysis. However, each question in a particular area of a strategic audit can be broken down into an additional series of sub-questions. An analyst can develop these sub-questions when they are needed for a complete strategic analysis of a company.

End of Chapter SUMMARY

Strategy scholars Donald Hambrick and James Fredrickson propose that a good strategy has five elements, providing answers to five questions:

1. Arenas: Where will we be active?
2. Vehicles: How will we get there?
3. Differentiators: How will we win in the marketplace?
4. Staging: What will be our speed and sequence of moves?
5. Economic logic: How will we obtain our returns?[88]

This chapter introduces you to a well-accepted model of strategic management (**Figure 1–2**) in which environmental scanning leads to strategy formulation, strategy implementation, and evaluation and control. It further shows how that model can be put into action

through the strategic decision-making process (**Figure 1–5**) and a strategic audit (**Appendix 1.A**). As pointed out by Hambrick and Fredrickson, "strategy consists of an integrated set of choices."[89] The questions "Where will we be active?" and "How will we get there?" are dealt with by a company's mission, objectives, and corporate strategy. The question "How will we win in the marketplace?" is the concern of business strategy. The question "What will be our speed and sequence of moves?" is answered not only by business strategy and tactics but also by functional strategy and by implemented programs, budgets, and procedures. The question "How will we obtain our returns?" is the primary emphasis of the evaluation and control element of the strategic management model. Each of these questions and topics will be dealt with in greater detail in the chapters to come. Welcome to the study of strategic management!

ECO-BITS

- The world's primary energy consumption by fuel in 2004 was 35% oil, 25% coal, 21% natural gas, 10% biomass and waste, 6% nuclear, 2% hydroelectric, and 1% other renewable.[90]
- The price per watt of photovoltaic modules used in solar power dropped from $18 in 1980 to $4 in 2007.[91]
- Since 1869 world crude oil prices, adjusted for inflation, have averaged $21.66 per barrel in 2006 dollars. By 2008, the price per barrel reached $140 for the first time in history.[92]

DISCUSSION QUESTIONS

1. Why has strategic management become so important to today's corporations?
2. How does strategic management typically evolve in a corporation?
3. What is a learning organization? Is this approach to strategic management better than the more traditional top-down approach in which strategic planning is primarily done by top management?
4. Why are strategic decisions different from other kinds of decisions?
5. When is the planning mode of strategic decision making superior to the entrepreneurial and adaptive modes?

STRATEGIC PRACTICE EXERCISES

Mission statements vary widely from one company to another. Why is one mission statement better than another? Using Campbell's questions in **Strategy Highlight 1.2** as a starting point, develop criteria for evaluating any mission statement. Then do one or both of the following exercises:

1. Evaluate the following mission statement of Celestial Seasonings. How many points would Campbell give it?

   Our mission is to grow and dominate the U.S. specialty tea market by exceeding consumer expectations with the best tasting, 100% natural hot and iced teas, packaged with Celestial art and philosophy, creating the most valued tea experience. Through leadership, innovation, focus, and teamwork, we are dedicated to continuously improving value to our consumers, customers, employees, and stakeholders with a quality-first organization.[93]
2. Using the Internet, find the mission statements of three different organizations, which can be business or not-for-profit. (Hint: Check annual reports and 10K forms. They can often be found via a link on a company's Web page or through Hoovers.com.) Which mission statement is best? Why?

KEY TERMS

budget (p. 22)
business strategy (p. 19)
corporate strategy (p. 19)
environmental scanning (p. 16)
environmental sustainability (p. 8)
evaluation and control (p. 22)
external environment (p. 16)
functional strategy (p. 20)
globalization (p. 8)

hierarchy of strategy (p. 20)
institution theory (p. 13)
internal environment (p. 16)
learning organization (p. 13)
mission (p. 17)
objective (p. 18)
organizational learning theory (p. 13)
performance (p. 22)
phases of strategic management (p. 5)
policy (p. 21)
population ecology (p. 12)
procedure (p. 22)
program (p. 21)
strategic audit (p. 28)
strategic choice perspective (p. 13)
strategic decision (p. 25)
strategic decision-making process (p. 27)
strategic factor (p. 16)
strategic management (p. 5)
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APPENDIX 1.A

Strategic Audit of a Corporation

I. Current Situation

A. Current Performance

How did the corporation perform the past year overall in terms of return on investment, market share, and profitability?

B. Strategic Posture

What are the corporation's current mission, objectives, strategies, and policies?

1. Are they clearly stated, or are they merely implied from performance?
2. **Mission:** What business(es) is the corporation in? Why?
3. **Objectives:** What are the corporate, business, and functional objectives? Are they consistent with each other, with the mission, and with the internal and external environments?
4. **Strategies:** What strategy or mix of strategies is the corporation following? Are they consistent with each other, with the mission and objectives, and with the internal and external environments?
5. **Policies:** What are the corporation's policies? Are they consistent with each other, with the mission, objectives, and strategies, and with the internal and external environments?
6. Do the current mission, objectives, strategies, and policies reflect the corporation's international operations, whether global or multidomestic?

II. Corporate Governance

A. Board of Directors

1. Who is on the board? Are they internal (employees) or external members?
2. Do they own significant shares of stock?
3. Is the stock privately held or publicly traded? Are there different classes of stock with different voting rights?
4. What do the board members contribute to the corporation in terms of knowledge, skills, background, and connections? If the corporation has international operations, do board members have international experience? Are board members concerned with environmental sustainability?

SOURCE: T.L. Wheelen, J.D. Hunger, Strategic Audit of a Corporation, Copyright © 1982 by Wheelen & Hunger Associates. Reprinted by permission. Revised 1988, 1991, 1994, 1997, 2000, 2002, 2005, and 2008.

5. How long have the board members served on the board?
6. What is their level of involvement in strategic management? Do they merely rubber-stamp top management's proposals or do they actively participate and suggest future directions? Do they evaluate management's proposals in terms of environmental sustainability?

B. Top Management

1. What person or group constitutes top management?
2. What are top management's chief characteristics in terms of knowledge, skills, background, and style? If the corporation has international operations, does top management have international experience? Are executives from acquired companies considered part of the top management team?
3. Has top management been responsible for the corporation's performance over the past few years? How many managers have been in their current position for less than three years? Were they promoted internally or externally hired?
4. Has top management established a systematic approach to strategic management?
5. What is top management's level of involvement in the strategic management process?
6. How well does top management interact with lower-level managers and with the board of directors?
7. Are strategic decisions made ethically in a socially responsible manner?
8. Are strategic decisions made in an environmentally sustainable manner?
9. Do top executives own significant amounts of stock in the corporation?
10. Is top management sufficiently skilled to cope with likely future challenges?

III. External Environment: Opportunities and Threats (SW**OT**)

A. Natural Physical Environment: Sustainability Issues

1. What forces from the natural physical environmental are currently affecting the corporation and the industries in which it competes? Which present current or future threats? Opportunities?
   a. Climate, including global temperature, sea level, and fresh water availability
   b. Weather-related events, such as severe storms, floods, and droughts
   c. Solar phenomena, such as sun spots and solar wind
2. Do these forces have different effects in other regions of the world?

B. Societal Environment

1. What general environmental forces are currently affecting both the corporation and the industries in which it competes? Which present current or future threats? Opportunities?
   a. Economic
   b. Technological
   c. Political–legal
   d. Sociocultural
2. Are these forces different in other regions of the world?

C. Task Environment

1. What forces drive industry competition? Are these forces the same globally or do they vary from country to country? Rate each force as **high, medium,** or **low.**
   a. Threat of new entrants
   b. Bargaining power of buyers
   c. Threat of substitute products or services
   d. Bargaining power of suppliers
   e. Rivalry among competing firms
   f. Relative power of unions, governments, special interest groups, etc.
2. What key factors in the immediate environment (that is, customers, competitors, suppliers, creditors, labor unions, governments, trade associations, interest groups, local communities, and shareholders) are currently affecting the corporation? Which are current or future Threats? Opportunities?

D. Summary of External Factors *(List in the EFAS Table 4–5, p. 126)*

Which of these forces and factors are the most important to the corporation and to the industries in which it competes at the present time? Which will be important in the future?

IV. Internal Environment: Strengths and Weaknesses (**SW**OT)

A. Corporate Structure

1. How is the corporation structured at present?
   a. Is the decision-making authority centralized around one group or decentralized to many units?
   b. Is the corporation organized on the basis of functions, projects, geography, or some combination of these?
2. Is the structure clearly understood by everyone in the corporation?
3. Is the present structure consistent with current corporate objectives, strategies, policies, and programs, as well as with the firm's international operations?
4. In what ways does this structure compare with those of similar corporations?

B. Corporate Culture

1. Is there a well-defined or emerging culture composed of shared beliefs, expectations, and values?
2. Is the culture consistent with the current objectives, strategies, policies, and programs?
3. What is the culture's position on environmental sustainability?
4. What is the culture's position on other important issues facing the corporation (that is, on productivity, quality of performance, adaptability to changing conditions, and internationalization)?
5. Is the culture compatible with the employees' diversity of backgrounds?
6. Does the company take into consideration the values of the culture of each nation in which the firm operates?

C. Corporate Resources

1. **Marketing**
   a. What are the corporation's current marketing objectives, strategies, policies, and programs?
      i. Are they clearly stated or merely implied from performance and/or budgets?
      ii. Are they consistent with the corporation's mission, objectives, strategies, and policies and with internal and external environments?
   b. How well is the corporation performing in terms of analysis of market position and marketing mix (that is, product, price, place, and promotion) in both domestic and international markets? How dependent is the corporation on a few customers? How big is its market? Where is it gaining or losing market share? What percentage of sales comes from developed versus developing regions? Where are current products in the product life cycle?
      i. What trends emerge from this analysis?
      ii. What impact have these trends had on past performance and how might these trends affect future performance?
      iii. Does this analysis support the corporation's past and pending strategic decisions?
      iv. Does marketing provide the company with a competitive advantage?
   c. How well does the corporation's marketing performance compare with that of similar corporations?
   d. Are marketing managers using accepted marketing concepts and techniques to evaluate and improve product performance? (Consider product life cycle, market segmentation, market research, and product portfolios.)
   e. Does marketing adjust to the conditions in each country in which it operates?
   f. Does marketing consider environmental sustainability when making decisions?
   g. What is the role of the marketing manager in the strategic management process?
2. **Finance**
   a. What are the corporation's current financial objectives, strategies, and policies and programs?
      i. Are they clearly stated or merely implied from performance and/or budgets?
      ii. Are they consistent with the corporation's mission, objectives, strategies, and policies and with internal and external environments?
   b. How well is the corporation performing in terms of financial analysis? (Consider ratio analysis, common size statements, and capitalization structure.) How balanced, in terms of cash flow, is the company's portfolio of products and businesses? What are investor expectations in terms of share price?
      i. What trends emerge from this analysis?
      ii. Are there any significant differences when statements are calculated in constant versus reported dollars?
      iii. What impact have these trends had on past performance and how might these trends affect future performance?
      iv. Does this analysis support the corporation's past and pending strategic decisions?
      v. Does finance provide the company with a competitive advantage?
   c. How well does the corporation's financial performance compare with that of similar corporations?
   d. Are financial managers using accepted financial concepts and techniques to evaluate and improve current corporate and divisional performance? (Consider financial leverage, capital budgeting, ratio analysis, and managing foreign currencies.)
   e. Does finance adjust to the conditions in each country in which the company operates?
   f. Does finance cope with global financial issues?
   g. What is the role of the financial manager in the strategic management process?

3. **Research and Development (R&D)**
   a. What are the corporation's current R&D objectives, strategies, policies, and programs?
      i. Are they clearly stated or merely implied from performance or budgets?
      ii. Are they consistent with the corporation's mission, objectives, strategies and policies and with internal and external environments?
      iii. What is the role of technology in corporate performance?
      iv. Is the mix of basic, applied, and engineering research appropriate given the corporate mission and strategies?
      v. Does R&D provide the company with a competitive advantage?
   b. What return is the corporation receiving from its investment in R&D?
   c. Is the corporation competent in technology transfer? Does it use concurrent engineering and cross-functional work teams in product and process design?
   d. What role does technological discontinuity play in the company's products?
   e. How well does the corporation's investment in R&D compare with the investments of similar corporations? How much R&D is being outsourced? Is the corporation using value-chain alliances appropriately for innovation and competitive advantage?
   f. Does R&D adjust to the conditions in each country in which the company operates?
   g. Does R&D consider environmental sustainability in product development and packaging?
   h. What is the role of the R&D manager in the strategic management process?
4. **Operations and Logistics**
   a. What are the corporation's current manufacturing/service objectives, strategies, policies, and programs?
      i. Are they clearly stated or merely implied from performance or budgets?
      ii. Are they consistent with the corporation's mission, objectives, strategies, and policies and with internal and external environments?
   b. What are the type and extent of operations capabilities of the corporation? How much is done domestically versus internationally? Is the amount of outsourcing appropriate to be competitive? Is purchasing being handled appropriately? Are suppliers and distributors operating in an environmentally sustainable manner? Which products have the highest and lowest profit margins?
      i. If the corporation is product oriented, consider plant facilities, type of manufacturing system (continuous mass production, intermittent job shop, or flexible manufacturing), age and type of equipment, degree and role of automation and/or robots, plant capacities and utilization, productivity ratings, and availability and type of transportation.
      ii. If the corporation is service oriented, consider service facilities (hospital, theater, or school buildings), type of operations systems (continuous service over time to same clientele or intermittent service over time to varied clientele), age and type of supporting equipment, degree and role of automation and use of mass communication devices (diagnostic machinery, video machines), facility capacities and utilization rates, efficiency ratings of professional and service personnel, and availability and type of transportation to bring service staff and clientele together.
   c. Are manufacturing or service facilities vulnerable to natural disasters, local or national strikes, reduction or limitation of resources from suppliers, substantial cost increases of materials, or nationalization by governments?
   d. Is there an appropriate mix of people and machines (in manufacturing firms) or of support staff to professionals (in service firms)?
   e. How well does the corporation perform relative to the competition? Is it balancing inventory costs (warehousing) with logistical costs (just-in-time)? Consider costs per unit of labor, material, and overhead; downtime; inventory control management and scheduling of service staff; production ratings; facility utilization percentages; and number of clients successfully treated by category (if service firm) or percentage of orders shipped on time (if product firm).

i. What trends emerge from this analysis?
ii. What impact have these trends had on past performance and how might these trends affect future performance?
iii. Does this analysis support the corporation's past and pending strategic decisions?
iv. Does operations provide the company with a competitive advantage?

f. Are operations managers using appropriate concepts and techniques to evaluate and improve current performance? Consider cost systems, quality control and reliability systems, inventory control management, personnel scheduling, TQM, learning curves, safety programs, and engineering programs that can improve efficiency of manufacturing or of service.
g. Do operations adjust to the conditions in each country in which it has facilities?
h. Do operations consider environmental sustainability when making decisions?
i. What is the role of the operations manager in the strategic management process?

5. **Human Resources Management (HRM)**
   a. What are the corporation's current HRM objectives, strategies, policies, and programs?
      i. Are they clearly stated or merely implied from performance and/or budgets?
      ii. Are they consistent with the corporation's mission, objectives, strategies, and policies and with internal and external environments?
   b. How well is the corporation's HRM performing in terms of improving the fit between the individual employee and the job? Consider turnover, grievances, strikes, layoffs, employee training, and quality of work life.
      i. What trends emerge from this analysis?
      ii. What impact have these trends had on past performance and how might these trends affect future performance?
      iii. Does this analysis support the corporation's past and pending strategic decisions?
      iv. Does HRM provide the company with a competitive advantage?
   c. How does this corporation's HRM performance compare with that of similar corporations?
   d. Are HRM managers using appropriate concepts and techniques to evaluate and improve corporate performance? Consider the job analysis program, performance appraisal system, up-to-date job descriptions, training and development programs, attitude surveys, job design programs, quality of relationships with unions, and use of autonomous work teams.
   e. How well is the company managing the diversity of its workforce? What is the company's record on human rights? Does the company monitor the human rights record of key suppliers and distributors?
   f. Does HRM adjust to the conditions in each country in which the company operates? Does the company have a code of conduct for HRM for itself and key suppliers in developing nations? Are employees receiving international assignments to prepare them for managerial positions?
   g. What is the role of outsourcing in HRM planning?
   h. What is the role of the HRM manager in the strategic management process?

6. **Information Technology (IT)**
   a. What are the corporation's current IT objectives, strategies, policies, and programs?
      i. Are they clearly stated or merely implied from performance and/or budgets?
      ii. Are they consistent with the corporation's mission, objectives, strategies, and policies and with internal and external environments?
   b. How well is the corporation's IT performing in terms of providing a useful database, automating routine clerical operations, assisting managers in making routine decisions, and providing information necessary for strategic decisions?
      i. What trends emerge from this analysis?
      ii. What impact have these trends had on past performance and how might these trends affect future performance?

iii. Does this analysis support the corporation's past and pending strategic decisions?
iv. Does IT provide the company with a competitive advantage?

c. How does this corporation's IT performance and stage of development compare with that of similar corporations? Is it appropriately using the Internet, intranet, and extranets?
d. Are IT managers using appropriate concepts and techniques to evaluate and improve corporate performance? Do they know how to build and manage a complex database, establish Web sites with firewalls and virus protection, conduct system analyses, and implement interactive decision-support systems?
e. Does the company have a global IT and Internet presence? Does it have difficulty with getting data across national boundaries?
f. What is the role of the IT manager in the strategic management process?

D. Summary of Internal Factors *(List in the IFAS Table 5–2, p.164)*

Which of these factors are core competencies? Which, if any, are distinctive competencies? Which of these factors are the most important to the corporation and to the industries in which it competes at the present time? Which might be important in the future? Which functions or activities are candidates for outsourcing?

V. Analysis of Strategic Factors (SWOT)

A. Situational Analysis *(List in SFAS Matrix, Figure 6–1, p. 179)*

Of the external (EFAS) and internal (IFAS) factors listed in III.D and IV.D, which are the strategic (most important) factors that strongly affect the corporation's present and future performance?

B. Review of Mission and Objectives

1. Are the current mission and objectives appropriate in light of the key strategic factors and problems?
2. Should the mission and objectives be changed? If so, how?
3. If they are changed, what will be the effects on the firm?

VI. Strategic Alternatives and Recommended Strategy

A. Strategic Alternatives *(See the TOWS Matrix, Figure 6–3, p. 182)*

1. Can the current or revised objectives be met through more careful implementation of those strategies presently in use (for example, fine-tuning the strategies)?
2. What are the major feasible alternative strategies available to the corporation? What are the pros and cons of each? Can corporate scenarios be developed and agreed on? (Alternatives must fit the natural physical environment, societal environment, industry, and corporation for the next three to five years.)
   a. Consider *stability*, *growth*, and *retrenchment* as corporate strategies.
   b. Consider *cost leadership* and *differentiation* as business strategies.

c. Consider any functional strategic alternatives that might be needed for reinforcement of an important corporate or business strategic alternative.

B. Recommended Strategy

1. Specify which of the strategic alternatives you are recommending for the corporate, business, and functional levels of the corporation. Do you recommend different business or functional strategies for different units of the corporation?
2. Justify your recommendation in terms of its ability to resolve both long- and short-term problems and effectively deal with the strategic factors.
3. What policies should be developed or revised to guide effective implementation?
4. What is the impact of your recommended strategy on the company's core and distinctive competencies?

VII. Implementation

A. What Kinds of Programs (for Example, Restructuring the Corporation or Instituting TQM) Should Be Developed to Implement the Recommended Strategy?

1. Who should develop these programs?
2. Who should be in charge of these programs?

B. Are the Programs Financially Feasible? Can Pro Forma Budgets Be Developed and Agreed On? Are Priorities and Timetables Appropriate to Individual Programs?

C. Will New Standard Operating Procedures Need to Be Developed?

VIII. Evaluation and Control

A. Is the Current Information System Capable of Providing Sufficient Feedback on Implementation Activities and Performance? Can It Measure Strategic Factors?

1. Can performance results be pinpointed by area, unit, project, or function?
2. Is the information timely?
3. Is the corporation using benchmarking to evaluate its functions and activities?

B. Are Adequate Control Measures in Place to Ensure Conformance with the Recommended Strategic Plan?

1. Are appropriate standards and measures being used?
2. Are reward systems capable of recognizing and rewarding good performance?

CHAPTER 2

corporate Governance

On paper, Robert Nardelli, seemed to be doing everything right. Selected personally by the founders, Arthur Blank, Kenneth Langone, and Bernard Marcus, the board of directors felt that the company was lucky to have hired Nardelli from General Electric to be CEO of Home Depot in December 2000. Between 2000 and 2005, the company opened more than 900 stores, doubled sales to $81.5 billion, and achieved earnings per share growth of at least 20% every year. According to Nardelli, the company had the strongest balance sheet in the industry and tremendous potential for future growth. The board loved Nardelli and had been happy to support his decisions.

The stockholders, however, were not as satisfied with Nardelli's performance. They wondered why Home Depot's common stock had fallen 30% since Nardelli had taken charge of the company. In addition, Nardelli was increasingly being attacked for having "excessive compensation," given the firm's poor stock performance. People questioned why he was receiving $38.1 million annually in salary, cash bonuses, and stock options. Nardelli was one of the six executives highlighted in a July 24, 2006 *Fortune* article entitled "The Real CEO Pay Problem."[1]

Stockholders were unhappy with Nardelli's tendency to manipulate negative performance data. For example, when same-store sales failed to increase in 2005, he announced that management would no longer report that figure. When a *Business Week* reporter questioned his persuading the board not to use stock price to decide his compensation, Nardelli responded that he and the board had felt that the leadership team should be measured on things over which the team had direct control, such as earnings per share instead of stock price compared to the retail index.[2]

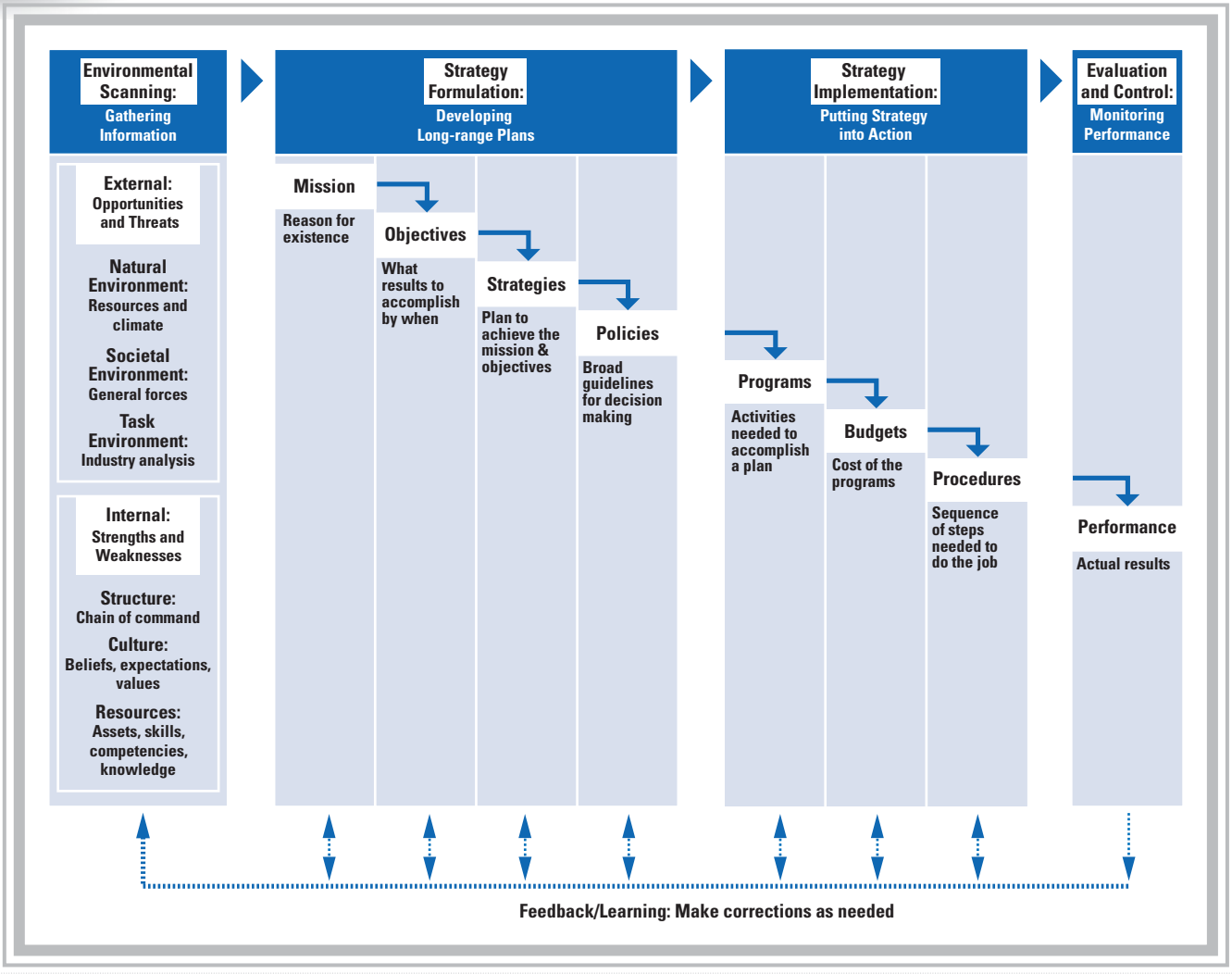
Since Nardelli saw little growth opportunity in the company's retail stores, he pushed to make the stores run more efficiently. Importing ideas, people, and management concepts from the military was one way to reshape an increasingly unwieldy Home Depot into a more centralized and efficient organization. Under Nardelli, the emphasis was on building a disciplined manager corps, one predisposed to following orders, operating in high-pressure environments, and executing with high standards.[3] He hired ex-military to be store managers. The previous constant flow of ideas and suggestions flowing up the organization from Home Depot's many employees was replaced by major decisions and goals flowing down from top management.

Former Home Depot executives reported that a "culture of fear" had caused customer service to decline. The once-heavy ranks of full-time store employees had been replaced with part-timers to reduce labor costs. Since 2001, 98% of Home Depot's 170 top executives had left the

Learning Objectives

After reading this chapter, you should be able to:

- Describe the role and responsibilities of the board of directors in corporate governance
- Understand how the composition of a board can affect its operation
- Describe the impact of the Sarbanes-Oxley Act on corporate governance in the United States
- Discuss trends in corporate governance
- Explain how executive leadership is an important part of strategic management



company. The University of Michigan's *American Customer Satisfaction Index*, compiled in 2005, revealed that Home Depot, with a score of 67, had slipped to last place among major U.S. retailers.

Nardelli did not react well to criticism. For example, the agenda for the May 2006 shareholders meeting contained a number of shareholder proposals dealing with "excessive" senior management compensation, separating the position of Chairman of the Board from another management position, requiring a majority (instead of plurality) vote for board member elections, shareholder approval for future "extraordinary" retirement benefits for senior executives, and disclosure of the monetary value of executive benefits. The votes on these proposals indicated an unusually high level of shareholder dissent, with at least one-third of shareholders voting for every proposal—votes cast before the meeting. Upon arriving at the annual shareholders meeting, people were surprised to note a number of changes from previous annual meetings. For one thing, except for CEO Nardelli, none of the members of the board of directors were present. For another, shareholders were allowed to speak about their shareholder proposals, but each had a time limit that was carefully tracked by a giant clock. Nardelli did not present a performance review, refused to acknowledge comments or answer questions, and adjourned the meeting after 30 minutes. Many of the shareholders were enraged by Nardelli's arrogance.

Pushed by the shareholders to reduce the CEO's large compensation package, the board of directors finally asked Nardelli to accept future stock awards being tied to increases in the company's stock price. Nardelli flatly refused and instead quit the company in January 2007—taking with him a $210 million retirement package. Observers could not understand why the board had been so generous with a CEO who during his tenure had been more concerned with building his own compensation than in building shareholder wealth.[4]

Home Depot's shareholders are not the only ones who are concerned with questionable top managers and weak boards of directors. A record 1,169 shareholder resolutions were proposed in the U.S. during 2007. Proposals on CEO pay and other governance issues received record high support votes of 30% to 60% from investors.[5] Successful shareholder activist campaigns increased in Europe from less than 10 in 2001 to over 50 in 2007.[6] Research revealing that managers at 29% of all U.S. public corporations had back-dated stock options in order to boost executive pay led to civil charges and shareholder lawsuits in addition to criminal indictments.[7] Board members are increasingly being held accountable for poor corporate governance. For example, 10 former directors from WorldCom and Enron agreed to pay $18 million and $13 million, respectively, of their own money to settle lawsuits launched by enraged stockholders over the unethical and even criminal actions of top management overseen by a passive board of directors.[8]

2.1 Role of the Board of Directors

A *corporation* is a mechanism established to allow different parties to contribute capital, expertise, and labor for their mutual benefit. The investor/shareholder participates in the profits of the enterprise without taking responsibility for the operations. Management runs the company without being responsible for personally providing the funds. To make this possible, laws have been passed that give shareholders limited liability and, correspondingly, limited involvement in a corporation's activities. That involvement does include, however, the right to elect directors who have a legal duty to represent the shareholders and protect their interests. As representatives of the shareholders, directors have both the authority and the responsibility to establish basic corporate policies and to ensure that they are followed.[9]

The board of directors, therefore, has an obligation to approve all decisions that might affect the long-run performance of the corporation. This means that the corporation is fundamentally governed by the *board of directors* overseeing *top management*, with the concurrence of the *shareholder.* The term **corporate governance** refers to the relationship among these three groups in determining the direction and performance of the corporation.[10]

Over the past decade, shareholders and various interest groups have seriously questioned the role of the board of directors in corporations. They are concerned that inside board members may use their position to feather their own nests and that outside board members often lack sufficient knowledge, involvement, and enthusiasm to do an adequate job of monitoring and providing guidance to top management. Instances of widespread corruption and questionable accounting practices at Enron, Global Crossing, WorldCom, Tyco, and Qwest, among others, seem to justify their concerns. Home Depot's board, for example, seemed more interested in keeping CEO Nardelli happy than in promoting shareholder interests.

The general public has not only become more aware and more critical of many boards' apparent lack of responsibility for corporate activities, it has begun to push government to demand accountability. As a result, the board as a rubber stamp of the CEO or as a bastion of the "old-boy" selection system is being replaced by more active, more professional boards.

RESPONSIBILITIES OF THE BOARD

Laws and standards defining the responsibilities of boards of directors vary from country to country. For example, board members in Ontario, Canada, face more than 100 provincial and federal laws governing director liability. The United States, however, has no clear national standards or federal laws. Specific requirements of directors vary, depending on the state in which the corporate charter is issued. There is, nevertheless, a developing worldwide consensus concerning the major responsibilities of a board. Interviews with 200 directors from eight countries (Canada, France, Germany, Finland, Switzerland, the Netherlands, the United Kingdom, and Venezuela) revealed strong agreement on the following five **board of director responsibilities**, listed in order of importance:

1. Setting corporate strategy, overall direction, mission, or vision
2. Hiring and firing the CEO and top management
3. Controlling, monitoring, or supervising top management
4. Reviewing and approving the use of resources
5. Caring for shareholder interests[11]

These results are in agreement with a survey by the National Association of Corporate Directors, in which U.S. CEOs reported that the four most important issues boards should

address are corporate performance, CEO succession, strategic planning, and corporate governance.[12] Directors in the United States must make certain, in addition to the duties just listed, that the corporation is managed in accordance with the laws of the state in which it is incorporated. Because more than half of all publicly traded companies in the United States are incorporated in the state of Delaware, this state's laws and rulings have more impact than do those of any other state.[13] Directors must also ensure management's adherence to laws and regulations, such as those dealing with the issuance of securities, insider trading, and other conflict-of-interest situations. They must also be aware of the needs and demands of constituent groups so that they can achieve a judicious balance among the interests of these diverse groups while ensuring the continued functioning of the corporation.

In a legal sense, the board is required to direct the affairs of the corporation but not to manage them. It is charged by law to act with **due care**. If a director or the board as a whole fails to act with due care and, as a result, the corporation is in some way harmed, the careless director or directors can be held personally liable for the harm done. This is no small concern given that one survey of outside directors revealed that more than 40% had been named as part of lawsuits against corporations.[14] For example, board members of Equitable Life in Britain were sued for up to $5.4 billion for failure to question the CEO's reckless policies.[15] For this reason, corporations have found that they need directors and officers' liability insurance in order to attract people to become members of boards of directors.

A 2008 global survey of directors by McKinsey & Company revealed the average amount of time boards spend on a given issue during their meetings:[16]

- Strategy (development and analysis of strategies)—24%
- Execution (prioritizing programs and approving mergers and acquisitions)—24%
- Performance management (development of incentives and measuring performance)—20%
- Governance and compliance (nominations, compensation, audits)—17%
- Talent management—11%

Role of the Board in Strategic Management

How does a board of directors fulfill these many responsibilities? The *role of the board of directors in strategic management* is to carry out three basic tasks:

- **Monitor:** By acting through its committees, a board can keep abreast of developments inside and outside the corporation, bringing to management's attention developments it might have overlooked. A board should at the minimum carry out this task.
- **Evaluate and influence:** A board can examine management's proposals, decisions, and actions; agree or disagree with them; give advice and offer suggestions; and outline alternatives. More active boards perform this task in addition to monitoring.
- **Initiate and determine:** A board can delineate a corporation's mission and specify strategic options to its management. Only the most active boards take on this task in addition to the two previous ones.

Board of Directors' Continuum

A board of directors is involved in strategic management to the extent that it carries out the three tasks of monitoring, evaluating and influencing, and initiating and determining. The **board of directors' continuum** shown in **Figure 2–1** shows the possible degree of involvement (from low to high) in the strategic management process. Boards can range from phantom boards with no real involvement to catalyst boards with a very high degree of involvement.[17] Research suggests that active board involvement in strategic management is positively related to a corporation's financial performance and its credit rating.[18]

FIGURE 2–1 Board of Directors' Continuum

Phantom	Rubber Stamp	Minimal Review	Nominal Participation	Active Participation	Catalyst
Never knows what to do, if anything; no degree of involvement.	Permits officers to make all decisions. It votes as the officers recommend on action issues.	Formally reviews selected issues that officers bring to its attention.	Involved to a limited degree in the performance or review of selected key decisions, indicators, or programs of managment.	Approves, questions, and makes final decisions on mission, strategy, policies, and objectives. Has active board committees. Performs fiscal and management audits.	Takes the leading role in establishing and modifying the mission, objectives, strategy, and policies. It has a very active strategy committee.

SOURCE: T. L. Wheelen and J. D. Hunger, "Board of Directors' Continuum," Copyright © 1994 by Wheelen and Hunger Associates. Reprinted by permission.

Highly involved boards tend to be very active. They take their tasks of monitoring, evaluating and influencing, and initiating and determining very seriously; they provide advice when necessary and keep management alert. As depicted in **Figure 2–1**, their heavy involvement in the strategic management process places them in the active participation or even catalyst positions. Although 74% of public corporations have periodic board meetings devoted primarily to the review of overall company strategy, the boards may not have had much influence in generating the plan itself.[19] A 2008 global survey of directors by McKinsey & Company found that 43% of respondents had high to very high influence in creating corporate value. Thirty-eight percent stated that they had moderate influence and 18% reported that they had little to very little influence. Those boards reporting high influence typically shared a common plan for creating value and had healthy debate about what actions the company should take to create value. Together with top management, these high-influence boards considered global trends and future scenarios and developed plans. In contrast, those boards with low influence tended not to do any of these things.[20] These results are supported by a 2006 survey by Korn/Ferry International revealing that 30% of directors felt that their CEO was not utilizing them to their full capacity. In the same study, 73% of the directors indicated that were not content with an oversight role mandated by regulation and wanted to be more involved in setting strategic plans.[21] Nevertheless, studies indicate that boards are becoming increasingly active. For example, in a global survey of directors conducted by McKinsey & Company in 2005, 64% of the respondents indicated that they were more actively involved in the core areas of company performance and value creation than they had been five years earlier. This percentage was higher in large companies (77%) and in publicly held companies (75%).[22]

These and other studies suggest that most large publicly owned corporations have boards that operate at some point between nominal and active participation. Some corporations with actively participating boards are Target, Medtronic, Best Western, Service Corporation International, Bank of Montreal, Mead Corporation, Rolm and Haas, Whirlpool, 3M, Apria Healthcare, General Electric, Pfizer, and Texas Instruments.[23] Target, a corporate governance leader, has a board that each year sets three top priorities, such as strategic direction, capital allocation, and succession planning. Each of these priority topics is placed at the top of the agenda

for at least one meeting. Target's board also devotes one meeting a year to setting the strategic direction for each major operating division.[24]

As a board becomes less involved in the affairs of the corporation, it moves farther to the left on the continuum (see **Figure 2–1**). On the far left are passive phantom or rubber-stamp boards that typically never initiate or determine strategy unless a crisis occurs. In these situations, the CEO also serves as Chairman of the Board, personally nominates all directors, and works to keep board members under his or her control by giving them the "mushroom treatment"—throw manure on them and keep them in the dark!

Generally, the smaller the corporation, the less active is its board of directors in strategic management.[25] In an entrepreneurial venture, for example, the privately held corporation may be 100% owned by the founders—who also manage the company. In this case, there is no need for an active board to protect the interests of the owner-manager shareholders—the interests of the owners and the managers are identical. In this instance, a board is really unnecessary and only meets to satisfy legal requirements. If stock is sold to outsiders to finance growth, however, the board becomes more active. Key investors want seats on the board so they can oversee their investment. To the extent that they still control most of the stock, however, the founders dominate the board. Friends, family members, and key shareholders usually become members, but the board acts primarily as a rubber stamp for any proposals put forward by the owner-managers. In this type of company, the founder tends to be both CEO and Chairman of the Board and the board includes few people who are not affiliated with the firm or family.[26] This cozy relationship between the board and management should change, however, when the corporation goes public and stock is more widely dispersed. The founders, who are still acting as management, may sometimes make decisions that conflict with the needs of the other shareholders (especially if the founders own less than 50% of the common stock). In this instance, problems could occur if the board fails to become more active in terms of its roles and responsibilities.

MEMBERS OF A BOARD OF DIRECTORS

The boards of most publicly owned corporations are composed of both inside and outside directors. **Inside directors** (sometimes called management directors) are typically officers or executives employed by the corporation. **Outside directors** (sometimes called non-management directors) may be executives of other firms but are not employees of the board's corporation. Although there is yet no clear evidence indicating that a high proportion of outsiders on a board results in improved financial performance,[27] there is a trend in the United States to increase the number of outsiders on boards and to reduce the total size of the board.[28] The board of directors of a typical large U.S. corporation has an average of 10 directors, 2 of whom are insiders.[29] Outsiders thus account for 80% of the board members in large U.S. corporations (approximately the same as in Canada). Boards in the UK typically have 5 inside and 5 outside directors, whereas in France boards usually consist of 3 insiders and 8 outsiders. Japanese boards, in contrast, contain 2 outsiders and 12 insiders.[30] The board of directors in a typical small U.S. corporation has four to five members, of whom only one or two are outsiders.[31] Research from large and small corporations reveals a negative relationship between board size and firm profitability.[32]

People who favor a high proportion of outsiders state that outside directors are less biased and more likely to evaluate management's performance objectively than are inside directors. This is the main reason why the U.S. Securities and Exchange Commission (SEC) in 2003 required that a majority of directors on the board be independent outsiders. The SEC also required that all listed companies staff their audit, compensation, and nominating/corporate governance committees entirely with independent, outside members. This view is in agreement with **agency theory**, which states that problems arise in corporations because the agents

(top management) are not willing to bear responsibility for their decisions unless they own a substantial amount of stock in the corporation. The theory suggests that a majority of a board needs to be from outside the firm so that top management is prevented from acting selfishly to the detriment of the shareholders. For example, proponents of agency theory argue that managers in management-controlled firms (contrasted with owner-controlled firms in which the founder or family still own a significant amount of stock) select less risky strategies with quick payoffs in order to keep their jobs.[33] This view is supported by research revealing that manager-controlled firms (with weak boards) are more likely to go into debt to diversify into unrelated markets (thus quickly boosting sales and assets to justify higher salaries for themselves), thus resulting in poorer long-term performance than owner-controlled firms.[34] Boards with a larger proportion of outside directors tend to favor growth through international expansion and innovative venturing activities than do boards with a smaller proportion of outsiders.[35] Outsiders tend to be more objective and critical of corporate activities. For example, research reveals that the likelihood of a firm engaging in illegal behavior or being sued declines with the addition of outsiders on the board.[36] Research on family businesses has found that boards with a larger number of outsiders on the board tended to have better corporate governance and better performance than did boards with fewer outsiders.[37]

In contrast, those who prefer inside over outside directors contend that outside directors are less effective than are insiders because the outsiders are less likely to have the necessary interest, availability, or competency. **Stewardship theory** proposes that, because of their long tenure with the corporation, insiders (senior executives) tend to identify with the corporation and its success. Rather than use the firm for their own ends, these executives are thus most interested in guaranteeing the continued life and success of the corporation. (See **Strategy Highlight 2.1** for a discussion of Agency Theory contrasted with Stewardship Theory.) Excluding all insiders but the CEO reduces the opportunity for outside directors to see potential successors in action or to obtain alternate points of view of management decisions. Outside directors may sometimes serve on so many boards that they spread their time and interest too thin to actively fulfill their responsibilities. The average board member of a U.S. Fortune 500 firm serves on three boards. Research indicates that firm performance decreases as the number of directorships held by the average board member increases.[38] Although only 40% of surveyed U.S. boards currently limit the number of directorships a board member may hold in other corporations, 60% limit the number of boards on which their CEO may be a member.[39]

Those who question the value of having more outside board members point out that the term *outsider* is too simplistic because some outsiders are not truly objective and should be considered more as insiders than as outsiders. For example, there can be:

1. **Affiliated directors**, who, though not really employed by the corporation, handle the legal or insurance work for the company or are important suppliers (thus dependent on the current management for a key part of their business). These outsiders face a conflict of interest and are not likely to be objective. As a result of recent actions by the U.S. Congress, Securities and Exchange Commission, New York Stock Exchange, and NASDAQ, affiliated directors are being banned from U.S. corporate boardrooms. U.S. boards can no longer include representatives of major suppliers or customers or even professional organizations that might do business with the firm, even though these people could provide valuable knowledge and expertise.[40] The New York Stock Exchange decided in 2004 that anyone paid by the company during the previous three years could not be classified as an independent outside director.[41]
2. **Retired executive directors**, who used to work for the company, such as the past CEO who is partly responsible for much of the corporation's current strategy and who probably groomed the current CEO as his or her replacement. In the recent past, many boards of large firms kept the firm's recently retired CEO on the board for a year or two after retirement as

STRATEGY highlight 2.1

AGENCY THEORY VERSUS STEWARDSHIP THEORY IN CORPORATE GOVERNANCE

Managers of large, modern publicly held corporations are typically not the owners. In fact, most of today's top managers own only nominal amounts of stock in the corporation they manage. The real owners (shareholders) elect boards of directors who hire managers as their agents to run the firm's day-to-day activities. Once hired, how trustworthy are these executives? Do they put themselves or the firm first?

Agency Theory. As suggested in the classic study by Berle and Means, top managers are, in effect, "hired hands" who may very likely be more interested in their personal welfare than that of the shareholders. For example, management might emphasize strategies, such as acquisitions, that increase the size of the firm (to become more powerful and to demand increased pay and benefits) or that diversify the firm into unrelated businesses (to reduce short-term risk and to allow them to put less effort into a core product line that may be facing difficulty) but that result in a reduction of dividends and/or stock price.

Agency theory is concerned with analyzing and resolving two problems that occur in relationships between principals (owners/shareholders) and their agents (top management):

1. The agency problem that arises when (a) the desires or objectives of the owners and the agents conflict or (b) it is difficult or expensive for the owners to verify what the agent is actually doing. One example is when top management is more interested in raising its own salary than in increasing stock dividends.
2. The risk-sharing problem that arises when the owners and agents have different attitudes toward risk. Executives may not select risky strategies because they fear losing their jobs if the strategy fails.

According to agency theory, the likelihood that these problems will occur increases when stock is widely held (that is, when no one shareholder owns more than a small percentage of the total common stock), when the board of directors is composed of people who know little of the company or who are personal friends of top management, and when a high percentage of board members are inside (management) directors.

To better align the interests of the agents with those of the owners and to increase the corporation's overall performance, agency theory suggests that top management have a significant degree of ownership in the firm and/or have a strong financial stake in its long-term performance. In support of this argument, research indicates a positive relationship between corporate performance and the amount of stock owned by directors.

Stewardship Theory. In contrast, stewardship theory suggests that executives tend to be more motivated to act in the best interests of the corporation than in their own self-interests. Whereas agency theory focuses on extrinsic rewards that serve the lower-level needs, such as pay and security, stewardship theory focuses on the higher-order needs, such as achievement and self-actualization. Stewardship theory argues that senior executives over time tend to view the corporation as an extension of themselves. Rather than use the firm for their own ends, these executives are most interested in guaranteeing the continued life and success of the corporation. The relationship between the board and top management is thus one of principal and steward, not principal and agent ("hired hand"). Stewardship theory notes that in a widely held corporation, the shareholder is free to sell his or her stock at any time. In fact, the average share of stock is held less than 10 months. A diversified investor or speculator may care little about risk at the company level—preferring management to assume extraordinary risk so long as the return is adequate. Because executives in a firm cannot easily leave their jobs when in difficulty, they are more interested in a merely satisfactory return and put heavy emphasis on the firm's continued survival. Thus, stewardship theory argues that in many instances top management may care more about a company's long-term success than do more short-term oriented shareholders.

For more information about agency and stewardship theory, see A. A. Berle and G. C. Means, *The Modern Corporation and Private Property* (NY: Macmillan, 1936). Also see J. H. Davis, F. D. Schoorman, and L. Donaldson, "Toward a Stewardship Theory of Management," *Academy of Management Review* (January 1997), pp. 20–47; P. J. Lane, A. A. Cannella, Jr. & M. H. Lubatkin, "Agency Problems as Antecedents to Unrelated Mergers and Diversification: Amihud and Lev Reconsidered," *Strategic Management Journal* (June 1998), pp. 555–578; M. L. Hayward and D. C. Hambrick, "Explaining the Premiums Paid for Large Acquisitions: Evidence of CEO Hubris," *Administrative Science Quarterly* (March 1997), pp. 103–127; and C. M. Christensen and S. D. Anthony, "Put Investors in their Place," *Business Week* (May 28, 2007), p. 108.

a courtesy, especially if he/she had performed well as the CEO. It is almost certain, however, that this person will not be able to objectively evaluate the corporation's performance. Because of the likelihood of a conflict of interest, only 31% of boards in the Americas, 25% in Europe, and 20% in Australasia now include the former CEO on their boards.[42]

3. **Family directors**, who are descendants of the founder and own significant blocks of stock (with personal agendas based on a family relationship with the current CEO). The Schlitz Brewing Company, for example, was unable to complete its turnaround strategy with a non-family CEO because family members serving on the board wanted their money out of the company, forcing it to be sold.[43]

The majority of outside directors are active or retired CEOs and COOs of other corporations. Others are major investors/shareholders, academicians, attorneys, consultants, former government officials, and bankers. Given that 66% of the outstanding stock in the largest U.S. and UK corporations is now owned by institutional investors, such as mutual funds and pension plans, these investors are taking an increasingly active role in board membership and activities.[44] For example, TIAA-CREF's Corporate Governance team monitors governance practices of the 4,000 companies in which it invests its pension funds through its Corporate Assessment Program. If its analysis of a company reveals problems, TIAA-CREF first sends letters stating its concerns, followed up by visits, and it finally sponsors a shareholder resolution in opposition to management's actions.[45] Institutional investors are also powerful in many other countries. In Germany, bankers are represented on almost every board—primarily because they own large blocks of stock in German corporations. In Denmark, Sweden, Belgium, and Italy, however, investment companies assume this role. For example, the investment company Investor casts 42.5% of the Electrolux shareholder votes, thus guaranteeing itself positions on the Electrolux board.

Boards of directors have been working to increase the number of women and minorities serving on boards. Korn/Ferry International reports that of the Fortune 1000 largest U.S. firms, 85% had at least one woman director in 2006 (compared to 69% in 1995), comprising 15% of total directors. Approximately one-half of the boards in Europe included a female director, comprising 9% of total directors. (The percentage of female directors in Europe in 2006 ranged from less than 1% in Portugal to almost 40% in Norway.)[46] Korn/Ferry's survey also revealed that 76% of the U.S. boards had at least one ethnic minority in 2006 (African-American, 47%; Latino, 19%; Asian, 10%) as director compared to only 47% in 1995, comprising around 14% of total directors.[47] Among the top 200 S&P companies in the U.S., however, 84% have at least one African-American director.[48] The globalization of business is having an impact on board membership. According to the Spencer Stuart executive recruiting firm, 33% of U.S. boards had an international director.[49] Europe was the most "globalized" region of the world, with most companies reporting one or more non-national directors.[50] Although Asian and Latin American boards are still predominantly staffed by nationals, they are working to add more international directors.[51]

Outside directors serving on the boards of large Fortune 1000 U.S. corporations annually earned on average $58,217 in cash plus an average of $75,499 in stock options. Most of the companies (63%) paid their outside directors an annual retainer plus a fee for every meeting attended.[52] Directors serving on the boards of small companies usually received much less compensation (around $10,000). One study found directors of a sample of large U.S. firms to hold on average 3% of their corporations' outstanding stock.[53]

The vast majority of inside directors are the chief executive officer and either the chief operating officer (if not also the CEO) or the chief financial officer. Presidents or vice presidents of key operating divisions or functional units sometimes serve on the board. Few, if any, inside directors receive any extra compensation for assuming this extra duty. Very rarely does a U.S. board include any lower-level operating employees.

Codetermination: Should Employees Serve on Boards?

Codetermination, the inclusion of a corporation's workers on its board, began only recently in the United States. Corporations such as Chrysler, Northwest Airlines, United Airlines (UAL), and Wheeling-Pittsburgh Steel added representatives from employee associations to their boards as part of union agreements or Employee Stock Ownership Plans (ESOPs). For example, United Airlines workers traded 15% in pay cuts for 55% of the company (through an ESOP) and 3 of the firm's 12 board seats. In this instance, workers represent themselves on the board not so much as employees but primarily as owners. At Chrysler, however, the United Auto Workers union obtained a temporary seat on the board as part of a union contract agreement in exchange for changes in work rules and reductions in benefits. This was at a time when Chrysler was facing bankruptcy in the late 1970s. In situations like this when a director represents an internal stakeholder, critics raise the issue of conflict of interest. Can a member of the board, who is privy to confidential managerial information, function, for example, as a union leader whose primary duty is to fight for the best benefits for his or her members? Although the movement to place employees on the boards of directors of U.S. companies shows little likelihood of increasing (except through employee stock ownership), the European experience reveals an increasing acceptance of worker participation (without ownership) on corporate boards.

Germany pioneered codetermination during the 1950s with a two-tiered system: (1) a supervisory board elected by shareholders and employees to approve or decide corporate strategy and policy and (2) a management board (composed primarily of top management) appointed by the supervisory board to manage the company's activities. Most other Western European countries have either passed similar codetermination legislation (as in Sweden, Denmark, Norway, and Austria) or use worker councils to work closely with management (as in Belgium, Luxembourg, France, Italy, Ireland, and the Netherlands).

Interlocking Directorates

CEOs often nominate chief executives (as well as board members) from other firms to membership on their own boards in order to create an interlocking directorate. A *direct* **interlocking directorate** occurs when two firms share a director or when an executive of one firm sits on the board of a second firm. An *indirect* interlock occurs when two corporations have directors who also serve on the board of a third firm, such as a bank.

Although the Clayton Act and the Banking Act of 1933 prohibit interlocking directorates by U.S. companies competing in the same industry, interlocking continues to occur in almost all corporations, especially large ones. Interlocking occurs because large firms have a large impact on other corporations and these other corporations, in turn, have some control over the firm's inputs and marketplace. For example, most large corporations in the United States, Japan, and Germany are interlocked either directly or indirectly with financial institutions.[54] Eleven of the 15 largest U.S. corporations have at least two board members who sit together on another board. Twenty percent of the 1,000 largest U.S. firms share at least one board member.[55]

Interlocking directorates are useful for gaining both inside information about an uncertain environment and objective expertise about potential strategies and tactics.[56] For example, Kleiner Perkins, a high-tech venture capital firm, not only has seats on the boards of the companies in which it invests, but it also has executives (which Kleiner Perkins hired) from one entrepreneurial venture who serve as directors on others. Kleiner Perkins refers to its network of interlocked firms as its *keiretsu*, a Japanese term for a set of companies with interlocking business relationships and share-holdings.[57] Family-owned corporations, however, are less likely to have interlocking directorates than are corporations with highly dispersed stock ownership, probably because family-owned corporations do not like to dilute their corporate control by adding outsiders to boardroom discussions.

There is some concern, however, when the chairs of separate corporations serve on each other's boards. Twenty-two such pairs of corporate chairs (who typically also served as their firm's CEO) existed in 2003. In one instance, the three chairmen of Anheuser-Busch, SBC Communications, and Emerson Electric served on all three of the boards. Typically a CEO sits on only one board in addition to his or her own—down from two additional boards in previous years. Although such interlocks may provide valuable information, they are increasingly frowned upon because of the possibility of collusion.[58] Nevertheless, evidence indicates that well-interlocked corporations are better able to survive in a highly competitive environment.[59]

NOMINATION AND ELECTION OF BOARD MEMBERS

Traditionally the CEO of a corporation decided whom to invite to board membership and merely asked the shareholders for approval in the annual proxy statement. All nominees were usually elected. There are some dangers, however, in allowing the CEO free rein in nominating directors. The CEO might select only board members who, in the CEO's opinion, will not disturb the company's policies and functioning. Given that the average length of service of a U.S. board member is for three three-year terms (but can range up to 20 years for some boards), CEO-friendly, passive boards are likely to result. This is especially likely given that only 7% of surveyed directors indicated that their company had term limits for board members. Nevertheless, 60% of U.S. boards and 58% of European boards have a mandatory retirement age—typically around 70.[60] Research reveals that boards rated as least effective by the Corporate Library, a corporate governance research firm, tend to have members serving longer (an average of 9.7 years) than boards rated as most effective (7.5 years).[61] Directors selected by the CEO often feel that they should go along with any proposal the CEO makes. Thus board members find themselves accountable to the very management they are charged to oversee. Because this is likely to happen, more boards are using a nominating committee to nominate new outside board members for the shareholders to elect. Ninety-seven percent of large U.S. corporations now use nominating committees to identify potential directors. This practice is less common in Europe where 60% of boards use nominating committees.[62]

Many corporations whose directors serve terms of more than one year divides the board into classes and staggers elections so that only a portion of the board stands for election each year. This is called a *staggered board.* Sixty-three percent of U.S. boards currently have staggered boards.[63] Arguments in favor of this practice are that it provides continuity by reducing the chance of an abrupt turnover in its membership and that it reduces the likelihood of electing people unfriendly to management (who might be interested in a hostile takeover) through cumulative voting. An argument against staggered boards is that they make it more difficult for concerned shareholders to curb a CEO's power—especially when that CEO is also Chairman of the Board. An increasing number of shareholder resolutions to replace staggered boards with annual elections of all board members are currently being passed at annual meetings.

When nominating people for election to a board of directors, it is important that nominees have previous experience dealing with corporate issues. For example, research reveals that a firm makes better acquisition decisions when the firm's outside directors have had experience with such decisions.[64]

A survey of directors of U.S. corporations revealed the following criteria in a good director:

- Willing to challenge management when necessary—95%
- Special expertise important to the company—67%
- Available outside meetings to advise management—57%
- Expertise on global business issues—41%

- Understands the firm's key technologies and processes—39%
- Brings external contacts that are potentially valuable to the firm—33%
- Has detailed knowledge of the firm's industry—31%
- Has high visibility in his or her field—31%
- Is accomplished at representing the firm to stakeholders—18%[65]

ORGANIZATION OF THE BOARD

The size of a board in the United States is determined by the corporation's charter and its bylaws, in compliance with state laws. Although some states require a minimum number of board members, most corporations have quite a bit of discretion in determining board size. The average large, publicly held U.S. firm has 10 directors on its board. The average small, privately-held company has four to five members. The average size of boards elsewhere is Japan, 14; Non-Japan Asia, 9; Germany, 16; UK, 10; and France, 11.[66]

Approximately 70% of the top executives of U.S. publicly held corporations hold the dual designation of Chairman and CEO. (Only 5% of the firms in the UK have a combined Chair/CEO.)[67] The combined Chair/CEO position is being increasingly criticized because of the potential for conflict of interest. The CEO is supposed to concentrate on strategy, planning, external relations, and responsibility to the board. The Chairman's responsibility is to ensure that the board and its committees perform their functions as stated in the board's charter. Further, the Chairman schedules board meetings and presides over the annual shareholders' meeting. Critics of having one person in the two offices ask how the board can properly oversee top management if the Chairman is also a part of top management. For this reason, the Chairman and CEO roles are separated by law in Germany, the Netherlands, South Africa, and Finland. A similar law has been considered in the United Kingdom and Australia. Although research is mixed regarding the impact of the combined Chair/CEO position on overall corporate financial performance, firm stock price and credit ratings both respond negatively to announcements of CEOs also assuming the Chairman position.[68] Research also shows that corporations with a combined Chair/CEO have a greater likelihood of fraudulent financial reporting when CEO stock options are not present.[69]

Many of those who prefer that the Chairman and CEO positions be combined agree that the outside directors should elect a **lead director**. This person is consulted by the Chair/CEO regarding board affairs and coordinates the annual evaluation of the CEO.[70] The lead director position is very popular in the United Kingdom, where it originated. Of those U.S. companies combining the Chairman and CEO positions, 96% had a lead director.[71] This is one way to give the board more power without undermining the power of the Chair/CEO. The lead director becomes increasingly important because 94% of U.S. boards in 2006 (compared to only 41% in 2002) held regular executive sessions without the CEO being present.[72] Nevertheless, there are many ways in which an unscrupulous Chair/CEO can guarantee a director's loyalty. Research indicates that an increase in board independence often results in higher levels of CEO ingratiation behavior aimed at persuading directors to support CEO proposals. Long-tenured directors who support the CEO may use social pressure to persuade a new board member to conform to the group. Directors are more likely to be recommended for membership on other boards if they "don't rock the boat" and engage in low levels of monitoring and control behavior.[73] Even in those situations when the board has a nominating committee composed only of outsiders, the committee often obtains the CEO's approval for each new board candidate.[74]

The most effective boards accomplish much of their work through committees. Although they do not usually have legal duties, most committees are granted full power to act with the authority of the board between board meetings. Typical standing committees (in order of

prevalence) are the audit (100%), compensation (99%), nominating (97%), corporate governance (94%), stock options (84%), director compensation (52%), and executive (43%) committees.[75] The executive committee is usually composed of two inside and two outside directors located nearby who can meet between board meetings to attend to matters that must be settled quickly. This committee acts as an extension of the board and, consequently, may have almost unrestricted authority in certain areas.[76] Except for the executive, finance, and investment committees, board committees are now typically staffed only by outside directors. Although each board committee typically meets four to five times annually, the average audit committee met nine times during 2006.[77]

IMPACT OF THE SARBANES-OXLEY ACT ON U.S. CORPORATE GOVERNANCE

In response to the many corporate scandals uncovered since 2000, the U.S. Congress passed the **Sarbanes-Oxley Act** in June 2002. This act was designed to protect shareholders from the excesses and failed oversight that characterized failures at Enron, Tyco, WorldCom, Adelphia Communications, Qwest, and Global Crossing, among other prominent firms. Several key elements of Sarbanes-Oxley were designed to formalize greater board independence and oversight. For example, the act requires that all directors serving on the audit committee be independent of the firm and receive no fees other than for services of the director. In addition, boards may no longer grant loans to corporate officers. The act has also established formal procedures for individuals (known as "whistleblowers") to report incidents of questionable accounting or auditing. Firms are prohibited from retaliating against anyone reporting wrongdoing. Both the CEO and CFO must certify the corporation's financial information. The act bans auditors from providing both external and internal audit services to the same company. It also requires that a firm identify whether it has a "financial expert" serving on the audit committee who is independent from management.

Although the cost to a large corporation of implementing the provisions of the law was $8.5 million in 2004, the first year of compliance, the costs to a large firm fell to $1–$5 million annually during the following years as accounting and information processes were refined and made more efficient.[78] Pitney Bowes, for example, saved more than $500,000 in 2005 simply by consolidating four accounts receivable offices into one. Similar savings were realized at Cisco and Genentech.[79] An additional benefit of the increased disclosure requirements is more reliable corporate financial statements. Companies are now reporting numbers with fewer adjustments for unusual charges and write-offs, which in the past have been used to boost reported earnings.[80] The new rules have also made it more difficult for firms to post-date executive stock options. "This is an unintended consequence of disclosure," remarked Gregory Taxin, CEO of Glass, Lewis & Company, a stock research firm.[81] See the **Global Issue** feature to learn how corporate governance is being improved in other parts of the world.

Improving Governance

In implementing the Sarbanes-Oxley Act, the U.S. Securities and Exchange Commission (SEC) required in 2003 that a company disclose whether it has adopted a code of ethics that applies to the CEO and to the company's principal financial officer. Among other things, the SEC requires that the audit, nominating, and compensation committees be staffed entirely by outside directors. The New York Stock Exchange reinforced the mandates of Sarbanes-Oxley by requiring that companies have a nominating/governance committee composed entirely of independent outside directors. Similarly, NASDAQ rules require that nominations for new directors be made by either a nominating committee of independent outsiders or by a majority of independent outside directors.[82]

GLOBAL issue

CORPORATE GOVERNANCE IMPROVEMENTS THROUGHOUT THE WORLD

Countries throughout the world are working to improve corporate governance. Provisions that are roughly equivalent to Sarbanes-Oxley are in place in France and Japan, while both China and Canada are implementing similar rules. In the UK, the Cadbury Report has led to revisions to the Combined Code of Conduct that have placed additional responsibilities on non-management directors, altered board and committee composition, and modified the roles of the CEO and Chairman. The adoption of recommendations from the government-sponsored Cromme Commission has reduced the power of management directors and increased the transparency of Germany's two-tier system of governance. Italy has implemented the Draghi Law of 1998 and the Preda Code of Conduct. Since many corporations in non-Japan Asia are family-controlled or have stock that is at least partially owned by the state, the Anglo-American system of corporate governance does not quite fit. Nevertheless, many of the changes in other parts of the world, such as CEO performance reviews and executive succession planning, are taking place in Asian corporations.

In an attempt to make Korean businesses more attractive to foreign investors, for example, the South Korean government recommended that companies listed on the stock exchange introduce a two-tiered structure. One structure was to consist entirely of non-executive (outside) directors. One of the few companies to immediately adopt this new system of governance was Pohang Iron & Steel Company Ltd. (POSCO), the world's largest steelmaker. POSCO was listed on the New York Stock Exchange and had significant operations in the United States, plus a joint venture with U.S. Steel. According to Youn-Gil Ro, Corporate Information Team Manager, "We needed professional advice on international business practices as well as American practices."

SOURCES: A. L. Nazareth, "Keeping SarbOx Is Crucial," *Business Week* (November 13, 2006), p. 134; *33rd Annual Board of Directors Study* (New York: Korn/Ferry International, 2007); C. A. Mallin, editor, *Handbook on International Corporate Governance* (Northampton, Massachusetts: Edward Elgar Publishing, 2006). *Globalizing the Board of Directors: Trends and Strategies* (New York: Conference Board, 1999), p. 16.

Partially in response to Sarbanes-Oxley, a survey of directors of Fortune 1000 U.S. companies by Mercer Delta Consulting and the University of Southern California revealed that 60% of directors were spending more time on board matters than before Sarbanes-Oxley, with 85% spending more time on their company's accounts, 83% more on governance practices, and 52% on monitoring financial performance.[83] Newly elected outside directors with financial management experience increased to 10% of all outside directors in 2003 from only 1% of outsiders in 1998.[84] Seventy-eight percent of Fortune 1000 U.S. boards in 2006 required that directors own stock in the corporation, compared to just 36% in Europe, and 26% in Asia.[85]

Evaluating Governance

To help investors evaluate a firm's corporate governance, a number of independent rating services, such as Standard & Poor's (S&P), Moody's, Morningstar, The Corporate Library, Institutional Shareholder Services (ISS), and Governance Metrics International (GMI), have established criteria for good governance. *Business Week* annually publishes a list of the best and worst boards of U.S. corporations. Whereas rating service firms like S&P, Moody's, and The Corporate Library use a wide mix of research data and criteria to evaluate companies, ISS and GMI have been criticized because they primarily use public records to score firms, using simple checklists.[86] In contrast, the S&P Corporate Governance Scoring System researches four major issues:

- Ownership Structure and Influence
- Financial Stakeholder Rights and Relations

- Financial Transparency and Information Disclosure
- Board Structure and Processes

Although the S&P scoring system is proprietary and confidential, independent research using generally accepted measures of S&P's four issues revealed that moving from the poorest- to the best-governed categories nearly doubled a firm's likelihood of receiving an investment-grade credit rating.[87]

Avoiding Governance Improvements

A number of corporations are concerned that various requirements to improve corporate governance will constrain top management's ability to effectively manage the company. For example, more U.S. public corporations have gone private in the years since the passage of Sarbanes-Oxley than before its passage. Other companies use multiple classes of stock to keep outsiders from having sufficient voting power to change the company. Insiders, usually the company's founders, get stock with extra votes, while others get second-class stock with fewer votes. For example, Brian Roberts, CEO of Comcast, owns "superstock" that represents only 0.4% of outstanding common stock but guarantees him one-third of the voting stock. The Investor Responsibility Research Center reports that 11.3% of the companies it monitored in 2004 had multiple classes, up from 7.5% in 1990.[88]

Another approach to sidestepping new governance requirements is being used by corporations such as Google, Infrasource Services, Orbitz, and W&T Offshore. If a corporation in which an individual group or another company controls more than 50% of the voting shares decides to become a "controlled company," the firm is then exempt from requirements by the New York Stock Exchange and NASDAQ that a majority of the board and all members of key board committees be independent outsiders. According to governance authority Jay Lorsch, this will result in a situation in which "the majority shareholders can walk all over the minority."[89]

TRENDS IN CORPORATE GOVERNANCE

The role of the board of directors in the strategic management of a corporation is likely to be more active in the future. Although neither the composition of boards nor the board leadership structure has been consistently linked to firm financial performance, better governance does lead to higher credit ratings and stock prices. A McKinsey survey reveals that investors are willing to pay 16% more for a corporation's stock if it is known to have good corporate governance. The investors explained that they would pay more because, in their opinion (1) good governance leads to better performance over time, (2) good governance reduces the risk of the company getting into trouble, and (3) governance is a major strategic issue.[90]

Some of today's trends in governance (particularly prevalent in the United States and the United Kingdom) that are likely to continue include the following:

- Boards are getting more involved not only in reviewing and evaluating company strategy but also in shaping it.
- Institutional investors, such as pension funds, mutual funds, and insurance companies, are becoming active on boards and are putting increasing pressure on top management to improve corporate performance. This trend is supported by a U.S. SEC requirement that a mutual fund must publicly disclose the proxy votes cast at company board meetings in its portfolio. This reduces the tendency for mutual funds to rubber-stamp management proposals.[91]
- Shareholders are demanding that directors and top managers own more than token amounts of stock in the corporation. Research indicates that boards with equity ownership use quantifiable, verifiable criteria (instead of vague, qualitative criteria) to evaluate the CEO.[92] When compensation committee members are significant shareholders, they tend

to offer the CEO less salary but with a higher incentive component than do compensation committee members who own little to no stock.[93]

- Non-affiliated outside (non-management) directors are increasing their numbers and power in publicly held corporations as CEOs loosen their grip on boards. Outside members are taking charge of annual CEO evaluations.
- Women and minorities are being increasingly represented on boards.
- Boards are establishing mandatory retirement ages for board members—typically around age 70.
- Boards are evaluating not only their own overall performance, but also that of individual directors.
- Boards are getting smaller—partially because of the reduction in the number of insiders but also because boards desire new directors to have specialized knowledge and expertise instead of general experience.
- Boards continue to take more control of board functions by either splitting the combined Chair/CEO into two separate positions or establishing a lead outside director position.
- Boards are eliminating 1970s anti-takeover defenses that served to entrench current management. In just one year, for example, 66 boards repealed their staggered boards and 25 eliminated poison pills.[94]
- As corporations become more global, they are increasingly looking for board members with international experience.
- Instead of merely being able to vote for or against directors nominated by the board's nominating committee, shareholders may eventually be allowed to nominate board members. This was originally proposed by the U.S. Securities and Exchange Commission in 2004, but was not implemented. Supported by the AFL-CIO, a more open nominating process would enable shareholders to vote out directors who ignore shareholder interests.[95]
- Society, in the form of special interest groups, increasingly expects boards of directors to balance the economic goal of profitability with the social needs of society. Issues dealing with workforce diversity and environmental sustainability are now reaching the board level. (See the **Environmental Sustainability Issue** feature for an example of a conflict between a CEO and the board of directors over environmental issues.)

2.2 The Role of Top Management

The top management function is usually conducted by the CEO of the corporation in coordination with the COO (Chief Operating Officer) or president, executive vice president, and vice presidents of divisions and functional areas.[96] Even though strategic management involves everyone in the organization, the board of directors holds top management primarily responsible for the strategic management of a firm.[97]

RESPONSIBILITIES OF TOP MANAGEMENT

Top management responsibilities, especially those of the CEO, involve getting things accomplished through and with others in order to meet the corporate objectives. Top management's job is thus multidimensional and is oriented toward the welfare of the total

ENVIRONMENTAL sustainability issue

CONFLICT AT THE BODY SHOP

When Anita Roddick opened the first Body Shop in 1976, she probably had no idea that she would become one of the first "green" business executives. She simply liked the idea of selling cosmetics in small sizes that were made from natural ingredients. By 1998, her entrepreneurial venture grew through franchising into a global business with 1,594 shops in 47 countries. Roddick's personal philosophy in favor of human rights, endangered wildlife, and the environment, while being strongly against the use of animals in testing cosmetics, became an inherent part of the company's philosophy of business. Reflecting an environmental awareness far in advance of other firms, the company's publication, *This Is the Body Shop,* stated: "We aim to avoid excessive packaging, to refill our bottles, and to recycle our packaging and use raw materials from renewable sources when technologically and economically feasible." The company drafted the European Union's *Eco-Management and Audit Regulation* in 1991 and the company's first environmental statement, *The Green Book*, in 1992.

The Body Shop became a publicly traded corporation in 1984 when it was listed on London's Unlisted Securities Market for just 95 pence per stock. By 1986, the stock price had increased ten-fold in value and was listed on the London Stock Exchange. The company grew quickly to be worth 700 million British pounds in 1991. Although the influx of money from the sale of stock enabled the company to expand throughout the world, there were disadvantages to having shareholders and a board of directors. Some shareholders began to complain that the company was diverting money into social projects instead of maximizing profits. Roddick had used her position as CEO to join the Body Shop with Greenpeace's "Save the Whales" campaign and to form alliances with Amnesty International and Friends of the Earth. Although the company continued to grow in size, its market value was declining by 1998. Tiring of Roddick's social and environmental "radicalism," the board forced her to resign as CEO. Roddick and her husband (with just 18% of the stock) remained on the board as co-chairmen until 2002, when they were replaced. Roddick continued to carry out public relations functions for the company and traveled the world in search of new product ideas, but no longer had any control over the strategic direction of the firm she had founded.

On March 17, 2006, the Body Shop's board agreed to the company's sale to L'Oreal for a premium of 34.2% over the company's stock price. The sale was perceived by observers as quite ironic, given that for years Anita Roddick had criticized L'Oreal for its animal testing practices and for its exploitation of women in the workplace. On its Web site, Naturewatch said: "We feel that the Body Shop has 'sold out' and is not standing on its principles." Animal rights activists and some consumers vowed to boycott Body Shop stores. Within three weeks of the announcement, the Body Shop's "satisfaction" rating compiled by BrandIndex fell 11 points, to 14, its "buzz" rating fell by 10 points, to −4, and its "general impression" fell by 3 points, to 19. One Body Shop customer reflected the widespread dissatisfaction: "The Body Shop used to be my high street "safe house," a place where I could walk into and know that what I bought was okay, that people were actually benefiting from my purchase. . . . By buying from the Body Shop, you are now no longer supporting ethical consumerism. If I want legitimate fair-trade, non-animal tested products, I can find them easily, at the same price, elsewhere."

SOURCES: E. A. Fogarty, J. P. Vincelette, and T. L. Wheelen, "The Body Shop International PLC: Anita Roddick, OBE," in T. L. Wheelen and J. D. Hunger, *Strategic Management and Business Policy*, 8th ed. (Upper Saddle River, NJ: Prentice Hall, 2002), pp. 7.1–7.26; D. Purkayastha and R. Fernando, *The Body Shop: Social Responsibility or Sustained Greenwashing?* (Hyderabad, India: ICFAI Center for Management Research, 2006).

organization. Specific top management tasks vary from firm to firm and are developed from an analysis of the mission, objectives, strategies, and key activities of the corporation. Tasks are typically divided among the members of the top management team. A diversity of skills can thus be very important. Research indicates that top management teams with a diversity of functional backgrounds, experiences, and length of time with the company tend to be significantly related to improvements in corporate market share and profitability.[98] In addition, highly diverse teams with some international experience tend to emphasize international

growth strategies and strategic innovation, especially in uncertain environments, to boost financial performance.[99] The CEO, with the support of the rest of the top management team, must successfully handle two primary responsibilities that are crucial to the effective strategic management of the corporation: (1) provide executive leadership and a strategic vision and (2) manage the strategic planning process.

Executive Leadership and Strategic Vision

Executive leadership is the directing of activities toward the accomplishment of corporate objectives. Executive leadership is important because it sets the tone for the entire corporation. A **strategic vision** is a description of what the company is capable of becoming. It is often communicated in the company's mission and vision statements (as described in **Chapter 1**). People in an organization want to have a sense of mission, but only top management is in the position to specify and communicate this strategic vision to the general workforce. Top management's enthusiasm (or lack of it) about the corporation tends to be contagious. The importance of executive leadership is illustrated by Steve Reinemund, past-CEO of PepsiCo: "A leader's job is to define overall direction and motivate others to get there."[100]

Successful CEOs are noted for having a clear strategic vision, a strong passion for their company, and an ability to communicate with others. They are often perceived to be dynamic and charismatic leaders—which is especially important for high firm performance and investor confidence in uncertain environments.[101] They have many of the characteristics of **transformational leaders**—that is, leaders who provide change and movement in an organization by providing a vision for that change.[102] For instance, the positive attitude characterizing many well-known industrial leaders—such as Bill Gates at Microsoft, Anita Roddick at the Body Shop, Richard Branson at Virgin, Steve Jobs at Apple Computer, Phil Knight at Nike, Bob Lutz at General Motors, and Louis Gerstner at IBM—has energized their respective corporations. These transformational leaders have been able to command respect and to influence strategy formulation and implementation because they tend to have three key characteristics:[103]

1. **The CEO articulates a strategic vision for the corporation:** The CEO envisions the company not as it currently is but as it can become. The new perspective that the CEO's vision brings to activities and conflicts gives renewed meaning to everyone's work and enables employees to see beyond the details of their own jobs to the functioning of the total corporation.[104] Louis Gerstner proposed a new vision for IBM when he proposed that the company change its business model from computer hardware to services: "If customers were going to look to an integrator to help them envision, design, and build end-to-end solutions, then the companies playing that role would exert tremendous influence over the full range of technology decisions—from architecture and applications to hardware and software choices."[105] In a survey of 1,500 senior executives from 20 different countries, when asked the most important behavioral trait a CEO must have, 98% responded that the CEO must convey "a strong sense of vision."[106]
2. **The CEO presents a role for others to identify with and to follow:** The leader empathizes with followers and sets an example in terms of behavior, dress, and actions. The CEO's attitudes and values concerning the corporation's purpose and activities are clear-cut and constantly communicated in words and deeds. For example, when design engineers at General Motors had problems with monitor resolution using the Windows operating system, Steve Ballmer, CEO of Microsoft, personally crawled under conference room tables to plug in PC monitors and diagnose the problem.[107] People know what to expect and have trust in their CEO. Research indicates that businesses in which the general manager has the trust of the employees have higher sales and profits with lower turnover than do businesses in which there is a lesser amount of trust.[108]

3. **The CEO communicates high performance standards and also shows confidence in the followers' abilities to meet these standards:** The leader empowers followers by raising their beliefs in their own capabilities. No leader ever improved performance by setting easily attainable goals that provided no challenge. Communicating high expectations to others can often lead to high performance.[109] The CEO must be willing to follow through by coaching people. As a result, employees view their work as very important and thus motivating.[110] Ivan Seidenberg, chief executive of Verizon Communications, was closely involved in deciding Verizon's strategic direction, and he showed his faith in his people by letting his key managers handle important projects and represent the company in public forums. "All of these people could be CEOs in their own right. They are warriors and they are on a mission," explained Seidenberg. Grateful for his faith in them, his managers were fiercely loyal both to him and the company.[111]

The negative side of confident executive leaders is that their very confidence may lead to *hubris*, in which their confidence blinds them to information that is contrary to a decided course of action. For example, overconfident CEOs tend to charge ahead with mergers and acquisitions even though they are aware that most acquisitions destroy shareholder value. Research by Tate and Malmendier found that "overconfident CEOs are more likely to conduct mergers than rational CEOs at any point in time. Overconfident CEOs view their company as undervalued by outside investors who are less optimistic about the prospects of the firm." Overconfident CEOs were most likely to make acquisitions when they could avoid selling new stock to finance them, and they were more likely to do deals that diversified their firm's lines of businesses.[112]

Managing the Strategic Planning Process

As business corporations adopt more of the characteristics of the learning organization, strategic planning initiatives can come from any part of an organization. A survey of 156 large corporations throughout the world revealed that, in two-thirds of the firms, strategies were first proposed in the business units and sent to headquarters for approval.[113] However, unless top management encourages and supports the planning process, strategic management is not likely to result. In most corporations, top management must initiate and manage the strategic planning process. It may do so by first asking business units and functional areas to propose strategic plans for themselves, or it may begin by drafting an overall corporate plan within which the units can then build their own plans. Research suggests that bottom-up strategic planing may be most appropriate in multidivisional corporations operating in relatively stable environments but that top-down strategic planning may be most appropriate for firms operating in turbulent environments.[114] Other organizations engage in concurrent strategic planning in which all the organization's units draft plans for themselves after they have been provided with the organization's overall mission and objectives.

Regardless of the approach taken, the typical board of directors expects top management to manage the overall strategic planning process so that the plans of all the units and functional areas fit together into an overall corporate plan. Top management's job therefore includes the tasks of evaluating unit plans and providing feedback. To do this, it may require each unit to justify its proposed objectives, strategies, and programs in terms of how well they satisfy the organization's overall objectives in light of available resources. If a company is not organized into business units, top managers may work together as a team to do strategic planning. CEO Jeff Bezos tells how this is done at Amazon.com:

> *We have a group called the S Team—S meaning "senior" [management]—that stays abreast of what the company is working on and delves into strategy issues. It meets for about four hours every Tuesday. Once or twice a year the S Team also gets together in a two-day meeting where*

different ideas are explored. Homework is assigned ahead of time. . . . Eventually we have to choose just a couple of things, if they're big, and make bets.[115]

In contrast to the seemingly continuous strategic planning being done at Amazon.com, most large corporations conduct the strategic planning process just once a year—often at off-site strategy workshops attended by senior executives.[116]

Many large organizations have a *strategic planning staff* charged with supporting both top management and the business units in the strategic planning process. This staff may prepare the background materials used in senior management's off-site strategy workshop. This planning staff typically consists of fewer than ten people, headed by a senior executive with the title of Director of Corporate Development or Chief Strategy Officer. The staff's major responsibilities are to:

1. Identify and analyze companywide strategic issues, and suggest corporate strategic alternatives to top management.
2. Work as facilitators with business units to guide them through the strategic planning process.[117]

End of Chapter SUMMARY

Who determines a corporation's performance? According to the popular press, it is the chief executive officer who seems to be personally responsible for a company's success or failure. When a company is in trouble, one of the first alternatives usually presented is to fire the CEO. That was certainly the case at the Walt Disney Company under Michael Eisner and Hewlett-Packard under Carly Fiorina. Both CEOs were first viewed as transformational leaders who made needed strategic changes to their companies. After a few years, both were perceived to be the primary reason for their company's poor performance and were fired by their boards. The truth is rarely this simple.

According to research by Margarethe Wiersema, firing the CEO rarely solves a corporation's problems. In a study of CEO turnover caused by dismissals and retirements in the 500 largest public U.S. companies, 71% of the departures were involuntary. In those firms in which the CEO was fired or asked to resign and replaced by another, Wiersema found *no* significant improvement in the company's operating earnings or stock price. She couldn't find a single measure suggesting that CEO dismissal had a positive effect on corporate performance! Wiersema placed the blame for the poor results squarely on the shoulders of the boards of directors. Boards typically lack an in-depth understanding of the business and consequently rely too heavily on executive search firms that know even less about the business. According to Wiersema, boards that successfully managed the executive succession process had three things in common:

- The board set the criteria for candidate selection based on the strategic needs of the company.
- The board set realistic performance expectations rather than demanding a quick fix to please the investment community.
- The board developed a deep understanding of the business and provided strong strategic oversight of top management, including thoughtful annual reviews of CEO performance.[118]

As noted at the beginning of this chapter, corporate governance involves not just the CEO or the board of directors. It involves the combined active participation of the board, top management, and shareholders. One positive result of the many corporate scandals occurring over

the past decade is the increased interest in governance. Institutional investors are no longer content to be passive shareholders. Thanks to new regulations, boards of directors are taking their responsibilities more seriously and including more independent outsiders on key oversight committees. Top managers are beginning to understand the value of working with boards as partners, not just as adversaries or as people to be manipulated. Although there will always be passive shareholders, rubber-stamp boards, and dominating CEOs, the simple truth is that good corporate governance means better strategic management.

ECO-BITS

- DuPont, originally founded in 1802 to make gunpowder and explosives, was a major producer in 1990 of nitrous oxides and fluorocarbons—gases with a global warming potential 310 and 11,700 times that of carbon dioxide, respectively.
- DuPont was the first company to phase-out CFCs and the first to develop and commercialize CFC alternatives for refrigeration and air conditioning.
- DuPont's reputation changed from "Top U.S. Polluter of 1995" to *Business Week*'s list of "Top Green Companies" in 2005; meanwhile, its earnings per share increased from $1 in 2003 to $3.25 in 2007.[119]

DISCUSSION QUESTIONS

1. When does a corporation need a board of directors?
2. Who should and should not serve on a board of directors? What about environmentalists or union leaders?
3. Should a CEO be allowed to serve on another company's board of directors?
4. What would be the result if the only insider on a corporation's board were the CEO?
5. Should all CEOs be transformational leaders? Would you like to work for a transformational leader?

STRATEGIC PRACTICE EXERCISE

A. Think of the **best manager** for whom you have ever worked. What was it about this person that made him or her such a good manager? Consider the following statements as they pertain to that person. Fill in the blank *in front of each statement* with one of the following values:

STRONGLY AGREE = 5; AGREE = 4; NEUTRAL = 3;
DISAGREE = 2; STRONGLY DISAGREE = 1.

1. ___ I respect him/her personally, and want to act in a way that merits his/her respect and admiration. ___

2. ___ I respect her/his competence about things she/he is more experienced about than I. ___

3. ___ He/she can give special help to those who cooperate with him/her. ___

4. ___ He/she can apply pressure on those who cooperate with him/her. ___

5. ___ He/she has a legitimate right, considering his/her position, to expect that his/her suggestions will be carried out. ___

6. ___ I defer to his/her judgment in areas with which he/she is more familiar than I. ___

7. ___ He/she can make things difficult for me if I fail to follow his/her advice. ___

8. ___ Because of his/her job title and rank, I am obligated to follow his/her suggestions. ___

9. ___ I can personally benefit by cooperating with him/her. ___

10. ___ Following his/her advice results in better decisions. ___

11. ___ I cooperate with him/her because I have high regard for him/her as an individual. ___

12. ___ He/she can penalize those who do not follow his/her suggestions. ___

13. ___ I feel I have to cooperate with him/her. ___

14. ___ I cooperate with him/her because I wish to be identified with him/her. ___

15. ___ Cooperating with him/her can positively affect my performance. ___

SOURCE: Questionnaire developed by J. D. Hunger from the article "Influence and Information: An Exploratory Investigation of the Boundary Role Person's Bases of Power" by Robert Spekman, *Academy of Management Journal*, March 1979. Copyright © 2004 by J. David Hunger.

B. Now think of the **worst manager** for whom you have ever worked. What was it about this person that made him or her such a poor manager? Please consider the statements above as they pertain to that person. Please place a number *after each statement* with one of the values from 5 = strongly agree to 1 = strongly disagree.

C. Add the values you marked for the best manager within each of the five categories of power below. Then do the same for the values you marked for the worst manager.

BEST MANAGER

Reward	Coercive	Legitimate	Referent	Expert
3.	4.	5.	1.	2.
9.	7.	8.	11.	6.
15.	12.	13.	14.	10.
Total	Total	Total	Total	Total

WORST MANAGER

Reward	Coercive	Legitimate	Referent	Expert
3.	4.	5.	1.	2.
9.	7.	8.	11.	6.
15.	12.	13.	14.	10.
Total	Total	Total	Total	Total

D. Consider the differences between how you rated your best and your worst manager. How different are the two profiles? In many cases, the best manager's profile tends to be similar to that of transformational leaders in that the best manager tends to score highest on referent, followed by expert and reward, power—especially when compared to the worst manager's profile. The worst manager often scores highest on coercive and legitimate power, followed by reward power. The results of this survey may help you to answer the fifth discussion question for this chapter.

KEY TERMS

affiliated director (p. 49)
agency theory (p. 48)
board of directors' continuum (p. 46)
board of director responsibilities (p. 45)
codetermination (p. 52)
corporate governance (p. 45)
due care (p. 46)
executive leadership (p. 60)
inside director (p. 48)
interlocking directorate (p. 52)
lead director (p. 54)
outside director (p. 48)
Sarbanes-Oxley Act (p. 55)
stewardship theory (p. 49)
strategic vision (p. 60)
top management responsibilities (p. 58)
transformational leader (p. 60)

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CHAPTER 3

social responsibility and ethics in Strategic Management

Only a few miles from the gleaming skyscrapers of prosperous Minneapolis was a neighborhood littered with shattered glass from stolen cars and derelict houses used by drug lords. During the 1990s, the Hawthorne neighborhood became a no-man's-land where gun battles terrified local residents and raised the per capita murder rate 70% higher than that of New York.

Executives at General Mills became concerned when the murder rate reached a record high in 1996. The company's headquarters was located just five miles away from Hawthorne, then the city's most violent neighborhood. Working with law enforcement, politicians, community leaders, and residents, General Mills spent $2.5 million and donated thousands of employee hours to help clean up Hawthorne. Crack houses were demolished to make way for a new elementary school. Dilapidated houses in the neighborhood's core were rebuilt. General Mills provided grants to help people buy Hawthorne's houses. By 2003, homicides were down 32% and robberies had declined 56% in Hawthorne.

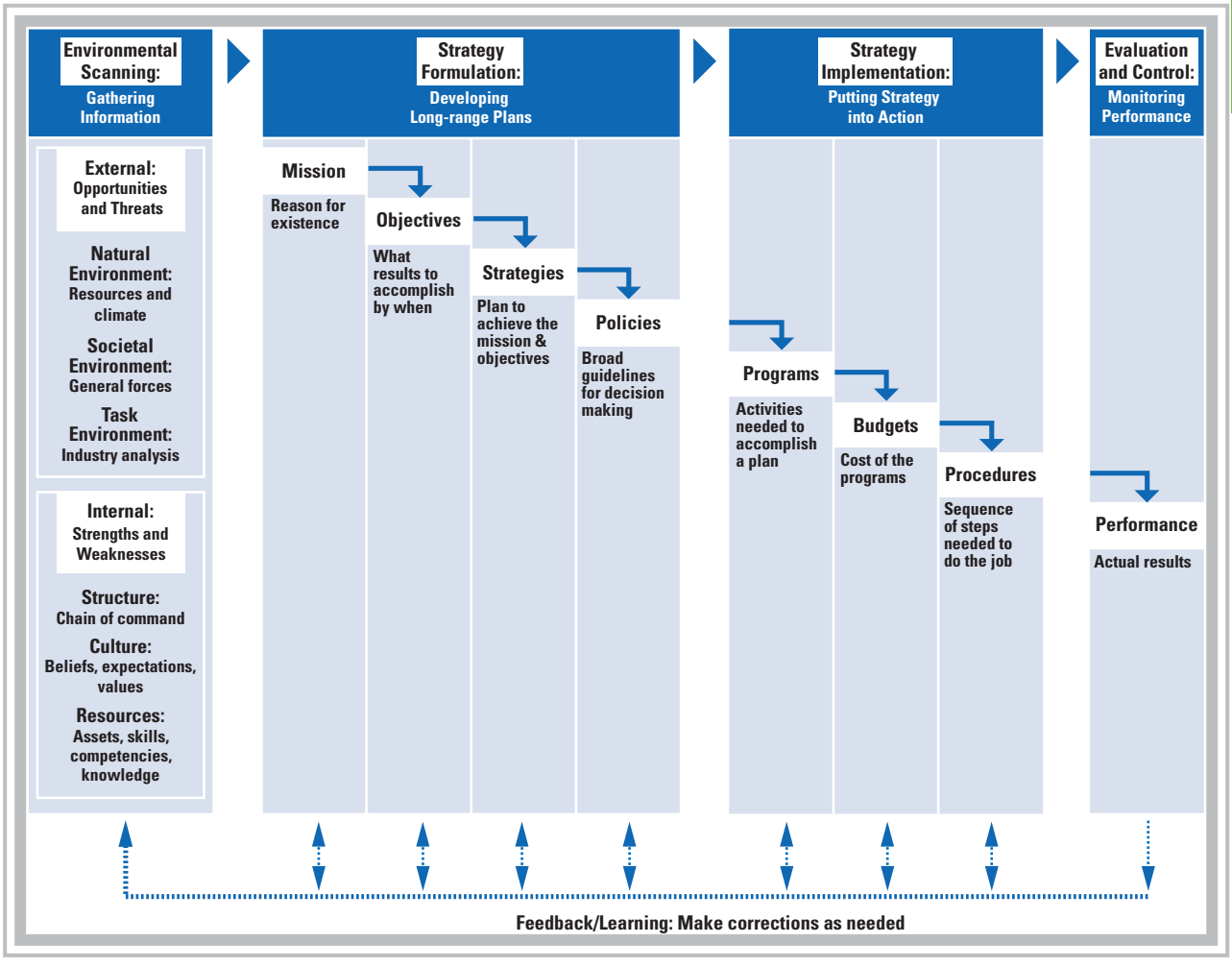
This story was nothing new for General Mills, a company often listed in *Fortune* magazine's "Most Admired Companies," ranked third most socially responsible company in a survey conducted by *The Wall Street Journal* and Harris Interactive, and fourth in *Business Week*'s 2007 survey of "most generous corporate donors." Since 2000, the company has annually contributed 5% of pretax profits to a wide variety of social causes. In 2007, for example, the company donated $82 million to causes ranging from education and the arts to social services. Every day, the company ships three truckloads of Cheerios, Wheaties, and other packaged goods to food banks throughout the nation. Community performance is even reflected in the performance reviews of top management. According to Christina Shea, president of General Mills Foundation, "We take as innovative approach to giving back to our communities as we do in our business." For joining with a nonprofit organization and a minority-owned food company to create 150 inner-city jobs, General Mills received *Business Ethics*' annual corporate citizenship award.[1]

Was this the best use of General Mills' time and money? At a time when companies were being pressured to cut costs and outsource jobs to countries with cheaper labor, what do business corporations owe their local communities? Should business firms give away shareholders' money, support social causes, and ask employees to donate their time to the community? Critics argue that this sort of thing is done best by government and not-for-profit charities. Isn't the primary goal of business to maximize profits, not to be a social worker?

Learning Objectives

After reading this chapter, you should be able to:

- Compare and contrast Friedman's traditional view with Carroll's contemporary view of social responsibility
- Understand the relationship between social responsibility and corporate performance
- Explain the concept of sustainability
- Conduct a stakeholder analysis
- Explain why people may act unethically
- Describe different views of ethics according to the utilitarian, individual rights, and justice approaches



3.1 Social Responsibilities of Strategic Decision Makers

Should strategic decision makers be responsible only to shareholders, or do they have broader responsibilities? The concept of **social responsibility** proposes that a private corporation has responsibilities to society that extend beyond making a profit. Strategic decisions often affect more than just the corporation. A decision to retrench by closing some plants and discontinuing product lines, for example, affects not only the firm's workforce but also the communities where the plants are located and the customers with no other source for the discontinued product. Such situations raise questions of the appropriateness of certain missions, objectives, and strategies of business corporations. Managers must be able to deal with these conflicting interests in an ethical manner to formulate a viable strategic plan.

RESPONSIBILITIES OF A BUSINESS FIRM

What are the responsibilities of a business firm and how many of them must be fulfilled? Milton Friedman and Archie Carroll offer two contrasting views of the responsibilities of business firms to society.

Friedman's Traditional View of Business Responsibility

Urging a return to a laissez-faire worldwide economy with a minimum of government regulation, Milton Friedman argues against the concept of social responsibility. A business person who acts "responsibly" by cutting the price of the firm's product to prevent inflation, or by making expenditures to reduce pollution, or by hiring the hard-core unemployed, according to Friedman, is spending the shareholder's money for a general social interest. Even if the businessperson has shareholder permission or encouragement to do so, he or she is still acting from motives other than economic and may, in the long run, harm the very society the firm is trying to help. By taking on the burden of these social costs, the business becomes less efficient—either prices go up to pay for the increased costs or investment in new activities and research is postponed. These results negatively affect—perhaps fatally—the long-term efficiency of a business. Friedman thus referred to the social responsibility of business as a "fundamentally subversive doctrine" and stated that:

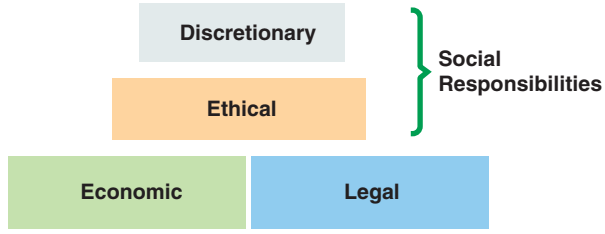
> *There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception or fraud.*[2]

Following Friedman's reasoning, the management of General Mills was clearly guilty of misusing corporate assets and negatively affecting shareholder wealth. The millions spent in social services could have been invested in new product development or given back as dividends to the shareholders. Instead of General Mills' management acting on its own, shareholders could have decided which charities to support.

Carroll's Four Responsibilities of Business

Friedman's contention that the primary goal of business is profit maximization is only one side of an ongoing debate regarding corporate social responsibility (CSR). According to William J. Byron, Distinguished Professor of Ethics at Georgetown University and past-President of Catholic University of America, profits are merely a means to an end, not an end in itself. Just as a person needs food to survive and grow, so does a business corporation need profits to survive and grow. "Maximizing profits is like maximizing food." Thus, contends Byron, maximization of profits cannot be the primary obligation of business.[3]

FIGURE 3–1
Responsibilities of Business



SOURCE: Based on A. B. Carroll, "A Three Dimensional Conceptual Model of Corporate Performance," *Academy of Management Review* (October 1979), pp. 497–505; A. B. Carroll, "Managing Ethically with Global Stakeholders: A Present and Future Challenge," *Academy of Management Executive* (May 2004), pp. 114–120; and A. B. Carroll, "The Pyramid of Corporate Social Responsibility: Toward the Moral Management of Organizational Stakeholders," *Business Horizons* (July–August 1991), pp. 39–48.

As shown in **Figure 3–1,** Archie Carroll proposes that the managers of business organizations have four responsibilities: economic, legal, ethical, and discretionary.[4]

1. **Economic** responsibilities of a business organization's management are to produce goods and services of value to society so that the firm may repay its creditors and shareholders.
2. **Legal** responsibilities are defined by governments in laws that management is expected to obey. For example, U.S. business firms are required to hire and promote people based on their credentials rather than to discriminate on non-job-related characteristics such as race, gender, or religion.
3. **Ethical** responsibilities of an organization's management are to follow the generally held beliefs about behavior in a society. For example, society generally expects firms to work with the employees and the community in planning for layoffs, even though no law may require this. The affected people can get very upset if an organization's management fails to act according to generally prevailing ethical values.
4. **Discretionary** responsibilities are the purely voluntary obligations a corporation assumes. Examples are philanthropic contributions, training the hard-core unemployed, and providing day-care centers. The difference between ethical and discretionary responsibilities is that few people expect an organization to fulfill discretionary responsibilities, whereas many expect an organization to fulfill ethical ones.[5]

Carroll lists these four responsibilities *in order of priority.* A business firm must first make a profit to satisfy its economic responsibilities. To continue in existence, the firm must follow the laws, thus fulfilling its legal responsibilities. There is evidence that companies found guilty of violating laws have lower profits and sales growth after conviction.[6] To this point Carroll and Friedman are in agreement. Carroll, however, goes further by arguing that business managers have responsibilities beyond economic and legal ones.

Having satisfied the two basic responsibilities, according to Carroll, a firm should look to fulfilling its social responsibilities. Social responsibility, therefore, includes both ethical and discretionary, but not economic and legal, responsibilities. A firm can fulfill its ethical responsibilities by taking actions that society tends to value but has not yet put into law. When ethical responsibilities are satisfied, a firm can focus on discretionary responsibilities—purely voluntary actions that society has not yet decided are important. For example, when Cisco Systems decided to dismiss 6,000 full-time employees, it provided a novel severance package. Those employees who agreed to work for a local nonprofit organization for a year would receive one-third of their salaries plus benefits and stock options and be the first to be rehired. Nonprofits were delighted to hire such highly qualified people and Cisco was able to maintain its talent pool for when it could hire once again.[7]

As societal values evolve, the discretionary responsibilities of today may become the ethical responsibilities of tomorrow. For example, in 1990, 86% of people in the U.S. believed that obesity was caused by the individuals themselves, with only 14% blaming either corporate marketing or government guidelines. By 2003, however, only 54% blamed obesity on individuals and 46% put responsibility on corporate marketing and government guidelines. Thus, the offering of healthy, low-calorie food by food processors and restaurants is moving rapidly from being a discretionary to an ethical responsibility.[8] One example of this change in values is the film documentary *Super Size Me*, which criticizes the health benefits of eating McDonald's deep-fried fast food. (McDonald's responded by offering more healthy food items.)

Carroll suggests that to the extent that business corporations fail to acknowledge discretionary or ethical responsibilities, society, through government, will act, making them legal responsibilities. Government may do this, moreover, without regard to an organization's economic responsibilities. As a result, the organization may have greater difficulty in earning a profit than it would have if it had voluntarily assumed some ethical and discretionary responsibilities.

Both Friedman and Carroll argue their positions based on the impact of socially responsible actions on a firm's profits. Friedman says that socially responsible actions hurt a firm's efficiency. Carroll proposes that a lack of social responsibility results in increased government regulations, which reduce a firm's efficiency.

Friedman's position on social responsibility appears to be losing traction with business executives. For example, a 2006 survey of business executives across the world by McKinsey & Company revealed that only 16% felt that business should focus solely on providing the highest possible returns to investors while obeying all laws and regulations, contrasted with 84% who stated that business should generate high returns to investors but balance it with contributions to the broader public good.[9] A 2007 survey of global executives by the Economist Intelligence Unit found that the percentage of companies giving either high or very high priority to corporate social responsibility had risen from less than 40% in 2004 to over 50% in 2007 and was expected to increase to almost 70% by 2010.[10]

Empirical research now indicates that socially responsible actions may have a positive effect on a firm's financial performance. Although a number of studies in the past have found no significant relationship,[11] an increasing number are finding a small, but positive relationship.[12] A recent in-depth analysis by Margolis and Walsh of 127 studies found that "there is a positive association and very little evidence of a negative association between a company's social performance and its financial performance."[13] Another meta-analysis of 52 studies on social responsibility and performance reached this same conclusion.[14]

According to Porter and Kramer, "social and economic goals are not inherently conflicting, but integrally connected."[15] Being known as a socially responsible firm may provide a company with *social capital*, the goodwill of key stakeholders, that can be used for competitive advantage.[16] Target, for example, tries to attract socially concerned younger consumers by offering brands from companies that can boost ethical track records and community involvement.[17] In a 2004 study conducted by the strategic marketing firm Cone, Inc., eight in ten Americans said that corporate support of social causes helps earn their loyalty. This was a 21% increase since 1997.[18]

Being socially responsible does provide a firm a more positive overall reputation.[19] A survey of more than 700 global companies by the Conference Board reported that 60% of the managers state that citizenship activities had led to (1) goodwill that opened doors in local communities and (2) an enhanced reputation with consumers.[20] Another survey of 140 U.S. firms revealed that being more socially responsible regarding environmental sustainability resulted not only in competitive advantages but also in cost savings.[21] For example, companies that take the lead in being environmentally friendly, such as by using recycled materials, preempt attacks from environmental groups and enhance their corporate image. Programs to

reduce pollution, for example, can actually reduce waste and maximize resource productivity. One study that examined 70 ecological initiatives taken by 43 companies found the average payback period to be 18 months.[22] Other examples of benefits received from being socially responsible are:[23]

- Their environmental concerns may enable them to charge premium prices and gain brand loyalty (for example, Ben & Jerry's Ice Cream).
- Their trustworthiness may help them generate enduring relationships with suppliers and distributors without requiring them to spend a lot of time and money policing contracts.
- They can attract outstanding employees who prefer working for a responsible firm (for example, Procter & Gamble and Starbucks).
- They are more likely to be welcomed into a foreign country (for example, Levi Strauss).
- They can utilize the goodwill of public officials for support in difficult times.
- They are more likely to attract capital infusions from investors who view reputable companies as desirable long-term investments. For example, mutual funds investing only in socially responsible companies more than doubled in size from 1995 to 2007 and outperformed the S&P 500 list of stocks.[24]

SUSTAINABILITY: MORE THAN ENVIRONMENTAL?

As a term, sustainability may include more than just ecological concerns and the natural environment. Crane and Matten point out that the concept of sustainability can be broadened to include economic and social as well as environmental concerns. They argue that it is sometimes impossible to address the sustainability of the natural environment without considering the social and economic aspects of relevant communities and their activities. For example, even though environmentalists may oppose road-building programs because of their effect on wildlife and conservation efforts, others point to the benefits to local communities of less traffic congestion and more jobs.[25] Dow Jones & Company, a leading provider of global business news and information, developed a sustainability index that considers not only environmental, but also economic and social factors. See the **Environmental Sustainability Issue** feature to learn the criteria Dow Jones uses in its index.

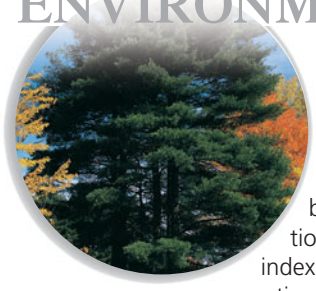
The broader concept of sustainability has much in common with Carroll's list of business responsibilities presented earlier. In order for a business corporation to be sustainable, that is, to be successful over a long period of time, it must satisfy all of its economic, legal, ethical, and discretionary responsibilities. Sustainability thus involves many issues, concerns, and tradeoffs—leading us to an examination of corporate stakeholders.

CORPORATE STAKEHOLDERS

The concept that business must be socially responsible sounds appealing until we ask, "Responsible to whom?" A corporation's task environment includes a large number of groups with interest in a business organization's activities. These groups are referred to as **stakeholders** because they affect or are affected by the achievement of the firm's objectives.[26] Should a corporation be responsible only to some of these groups, or does business have an equal responsibility to all of them?

A survey of the U.S. general public by Harris Poll revealed that 95% of the respondents felt that U.S. corporations owe something to their workers and the communities in which they operate and that they should sometimes sacrifice some profit for the sake of making things better for their workers and communities. People were concerned that business executives seemed to

ENVIRONMENTAL sustainability issue



THE DOW JONES SUSTAINABILITY INDEX

Dow Jones & Company, a leading provider of global business news and information, pioneered in 1999 the first index of common stocks that rates corporations according to their performance on sustainability. This index has grown to include multiple sustainability indexes, such as a World Index, North America Index, and United States Index, among others. The Dow Jones Sustainability Index (DJSI) follows a "best in class" approach that identifies sustainability leaders in each industry. Companies are evaluated against general and industry-specific criteria and ranked with their peers. Data come from questionnaires, submitted documentation, corporate policies, reports, and available public information. Since its inception, the Dow Jones Sustainability Index has slightly outperformed its well-known Dow Jones Industrial Index. Based on SAM (Sustainable Asset Management AG) Research's corporate sustainability assessment, Dow Jones includes not only environmental, but also economic and social criteria in its sustainability index.

- **Environmental sustainability.** This includes environmental reporting, eco-design and efficiency, environmental management systems, and executive commitment to environmental issues.
- **Economic sustainability.** This includes codes of conduct and compliance, anti-corruption policies, corporate governance, risk and crisis management, strategic planning, quality and knowledge management, and supply chain management.
- **Social sustainability.** This includes corporate citizenship, philanthropy, labor practices, human capital development, social reporting, talent attraction and retention, and stakeholder dialogue.

NOTE: For more information on SAM Sustainable Asset Management, see *Sustainability Yearbook 2008*, available from PriceWaterHouseCoopers (www.pwc.com).

SOURCES: Dow Jones Indexes Web site (www.djindexes.com/) as of July 15, 2008 and A. Crane and D. Matten, *Business Ethics: A European Perspective* (Oxford: Oxford University Press, 2004), pp. 214–215.

be more interested in making profits and boosting their own pay than they were in the safety and quality of the products made by their companies.[27] The percentage of the U.S. general public that agreed that business leaders could be trusted to do what is right "most of the time or almost always" fell from 36% in 2002 to 28% in 2006.[28] These negative feelings receive some support from a study that revealed that the CEOs at the 50 U.S. companies that outsourced the greatest number of jobs received a greater increase in pay than did the CEOs of 365 U.S. firms overall.[29]

In any one strategic decision, the interests of one stakeholder group can conflict with those of another. For example, a business firm's decision to use only recycled materials in its manufacturing process may have a positive effect on environmental groups but a negative effect on shareholder dividends. In another example, Maytag Corporation's top management decided to move refrigerator production from Galesburg, Illinois, to a lower-wage location in Mexico. On the one hand, shareholders were generally pleased with the decision because it would lower costs. On the other hand, officials and local union people were very unhappy at the loss of jobs when the Galesburg plant closed. Which group's interests should have priority?

In order to answer this question, the corporation may need to craft an *enterprise strategy*—an overarching strategy that explicitly articulates the firm's ethical relationship with its stakeholders. This requires not only that management clearly state the firm's key ethical values, but also that it understands the firm's societal context, and undertakes stakeholder analysis to identify the concerns and abilities of each stakeholder.[30]

Stakeholder Analysis

Stakeholder analysis is the identification and evaluation of corporate stakeholders. This can be done in a three-step process.

The *first step* in stakeholder analysis is to identify primary stakeholders, those who have a *direct connection* with the corporation and who have sufficient bargaining power to *directly* affect corporate activities. Primary stakeholders are directly affected by the corporation and usually include customers, employees, suppliers, shareholders, and creditors.

But who exactly are a firm's customers or employees and what do they want? This is not always a simple exercise. For example, Intel's customers were clearly computer manufacturers because that's to whom Intel sold its electronic chips. When a math professor found a small flaw in Intel's Pentium microprocessor in 1994, computer users demanded that Intel replace the defective chips. At first Intel refused to do so because it hadn't sold to these individuals. According to then-CEO Andy Grove, "I got irritated and angry because of user demands that we take back a device we didn't sell." Intel wanted the PC users to follow the supply chain and complain to the firms from whom they had bought the computers. Gradually Grove was persuaded that Intel had a direct duty to these consumers. "Although we didn't sell to these individuals directly, we marketed to them. . . . It took me a while to understand this," explained Grove. In the end, Intel paid $450 million to replace the defective parts.[31]

Aside from the Intel example, business corporations usually know their primary stakeholders and what they want. The corporation systematically monitors these stakeholders because they are important to a firm's meeting its economic and legal responsibilities. Employees want a fair day's pay and fringe benefits. Customers want safe products and value for price paid. Shareholders want dividends and stock price appreciation. Suppliers want predictable orders and bills paid. Creditors want commitments to be met on time. In the normal course of affairs, the relationship between a firm and each of its primary stakeholders is regulated by written or verbal agreements and laws. Once a problem is identified, negotiation takes place based on costs and benefits to each party. (Government is not usually considered a primary stakeholder because laws apply to all in a category and usually cannot be negotiated.)

The *second step* in stakeholder analysis is to identify the *secondary stakeholders*—those who have only an *indirect* stake in the corporation but who are also affected by corporate activities. These usually include nongovernmental organizations (NGOs, such as Greenpeace), activists, local communities, trade associations, competitors, and governments. Because the corporation's relationship with each of these stakeholders is usually not covered by any written or verbal agreement, there is room for misunderstanding. As in the case of NGOs and activists, there actually may be no relationship until a problem develops—usually brought up by the stakeholder. In the normal course of events, these stakeholders do not affect the corporation's ability to meet its economic or legal responsibilities. Aside from competitors, these secondary stakeholders are not usually monitored by the corporation in any systematic fashion. As a result, relationships are usually based on a set of questionable assumptions about each other's needs and wants. Although these stakeholders may not directly affect a firm's short-term profitability, their actions could determine a corporation's reputation and thus its long-term performance.

The *third step* in stakeholder analysis is to estimate the effect on each stakeholder group from any particular strategic decision. Because the primary decision criteria are typically economic, this is the point where secondary stakeholders may be ignored or discounted as unimportant. For a firm to fulfill its ethical or discretionary responsibilities, it must seriously consider the needs and wants of its secondary stakeholders in any strategic decision. For example, how much will specific stakeholder groups lose or gain? What other alternatives do they have to replace what may be lost?

Stakeholder Input

Once stakeholder impacts have been identified, managers should decide whether stakeholder input should be invited into the discussion of the strategic alternatives. A group is more likely to accept or even help implement a decision if it has some input into which

alternative is chosen and how it is to be implemented. In the case of Maytag's decision to close its Galesburg, Illinois, refrigeration plant, the community was not a part of the decision. Nevertheless, management decided to inform the local community of its decision three years in advance of the closing instead of the 60 days required by law. Although the announcement created negative attention, it gave the Galesburg employees and townspeople more time to adjust to the eventual closing.

Given the wide range of interests and concerns present in any organization's task environment, one or more groups, at any one time, probably will be dissatisfied with an organization's activities—even if management is trying to be socially responsible. A company may have some stakeholders of which it is only marginally aware. For example, when Ford Motor Company extended its advertising to magazines read by gay and lesbian readers in 2005, management had no idea that the American Family Association (AFA) would argue that this was tantamount to promoting a homosexual agenda and call for a boycott of all Ford products. In response, Ford pulled its ads. Gay and lesbian groups then protested Ford's backpedaling. Ford then placed corporate ads in many of the same publications, which gays saw as clumsy and the AFA saw as backsliding.[32]

Therefore, before making a strategic decision, strategic managers should consider how each alternative will affect various stakeholder groups. What seems at first to be the best decision because it appears to be the most profitable may actually result in the worst set of consequences to the corporation. One example of a company that does its best to consider its responsibilities to its primary and secondary stakeholders when making strategic decisions is Johnson & Johnson. See **Strategy Highlight 3.1** for the J & J Credo.

STRATEGY highlight 3.1

JOHNSON & JOHNSON CREDO

We believe our first responsibility is to the doctors, nurses, and patients, to mothers and fathers and all others who use our products and services. In meeting their needs everything we do must be of high quality. We must constantly strive to reduce our costs in order to maintain reasonable prices. Customers' orders must be serviced promptly and accurately. Our suppliers and distributors must have an opportunity to make a fair profit.

We are responsible to our employees, the men and women who work with us throughout the world. Everyone must be considered as an individual. We must respect their dignity and recognize their merit. They must have a sense of security in their jobs. Compensation must be fair and adequate, and working conditions clean, orderly, and safe. We must be mindful of ways to help our employees fulfill their family responsibilities. Employees must feel free to make suggestions and complaints. There must be equal opportunity for employment, development, and advancement for those qualified. We must provide competent management, and their actions must be just and ethical.

We are responsible to the communities where we live and work and to the world community as well. We must be good citizens—support good works and charities and bear our fair share of taxes. We must encourage civic improvements and better health and education. We must maintain in good order the property we are privileged to use, and protecting the environment and natural resources.

Our final responsibility is to our stockholders. Business must make a sound profit. We must experiment with new ideas. Research must be carried on, innovative programs developed, and mistakes paid for. New equipment must be purchased, new facilities provided, and new products launched. Reserves must be created for adverse times. When we operate according to these principles, the stockholders should realize a fair return.

SOURCE: Johnson & Johnson Company Web site, September 28, 2004. (http://www.jnj.com) Copyright by Johnson & Johnson. All rights reserved. Reprinted by permission.

3.2 Ethical Decision Making

Some people joke that there is no such thing as "business ethics." They call it an oxymoron—a concept that combines opposite or contradictory ideas. Unfortunately, there is some truth to this sarcastic comment. For example, a survey by the Ethics Resource Center of 1,324 employees of 747 U.S. companies found that 48% of employees surveyed said that they had engaged in one or more unethical and/or illegal actions during the past year. The most common questionable behaviors involved cutting corners on quality (16%), covering up incidents (14%), abusing or lying about sick days (11%), and lying to or deceiving customers (9%).[33] Some 52% of workers reported observing at least one type of misconduct in the workplace, but only 55% reported it.[34] From 1996 to 2005, top managers at 2,270 firms (29.2% of the firms analyzed) had backdated or otherwise manipulated stock option grants to take advantage of favorable share-price movements.[35] In a survey, 53% of employees in corporations of all sizes admitted that they would be willing to misrepresent corporate financial statements if asked to do so by a superior.[36] A survey of 141 chief financial executives (CFOs) revealed that 17% had been pressured by their CEOs over a five-year period to misrepresent the company's financial results. Five percent admitted that they had succumbed to the request.[37]

Around 53,000 cases of suspected mortgage fraud were reported by banks in 2007. The most common type of mortgage fraud was misstatement of income or assets, followed by forged documents, inflated appraisals, and misrepresentation of a buyer's intent to occupy a property as a primary residence.[38] In one instance, Allison Bice, office manager at Leonard Fazio's RE/MAX A-1 Best Realtors in Urbandale, Iowa, admitted that she submitted fake invoices and copies of checks drawn on a closed account as part of a scheme to obtain more money from Homecoming Financial, a mortgage company that had hired Fazio's agency to resell foreclosed homes. "I was directed by Mr. Fazio to have the bills be larger to Homecomings because we didn't make much money on commissions," Bice told a federal jury in Des Moines. "He told me that everybody in the business does it."[39]

A study of more than 5,000 graduate students at 32 colleges and universities in the United States and Canada revealed that 56% of business students and 47% of non-business students admitted to cheating at least once during the past year. Cheating was more likely when a student's peers also cheated.[40] In another example, 6,000 people paid $30 to enter a VIP section on ScoreTop.com's Web site to obtain access to actual test questions posted by those who had recently taken the Graduate Management Admission Test (GMAT). In response, the Graduate Management Admission Council promised to cancel the scores of anyone who posted "live" questions to the site or knowingly read them.[41] Given this lack of ethical behavior among students, it is easy to understand why some could run into trouble if they obtained a job at a corporation having an unethical culture, such as Enron, WorldCom, or Tyco. (See **Strategy Highlight 3.2** for examples of unethical practices at Enron and Worldcom.)

SOME REASONS FOR UNETHICAL BEHAVIOR

Why are many business people perceived to be acting unethically? It may be that the involved people are not even aware that they are doing something questionable. There is no worldwide standard of conduct for business people. This is especially important given the global nature of business activities. Cultural norms and values vary between countries and even between different geographic regions and ethnic groups within a country. For example, what is considered in one country to be a bribe to expedite service is sometimes considered in another country to be normal business practice. Some of these differences may derive from whether a country's

STRATEGY highlight 3.2

UNETHICAL PRACTICES AT ENRON AND WORLDCOM EXPOSED BY "WHISTLE-BLOWERS"

Corporate scandals at Enron, WorldCom, and Tyco, among other international companies, have caused people around the world to seriously question the ethics of business executives. Enron, in particular, has become infamous for the questionable actions of its top executives in the form of (1) off-balance sheet partnerships used to hide the company's deteriorating finances, (2) revenue from long-term contracts being recorded in the first year instead of being spread over multiple years, (3) financial reports being falsified to inflate executive bonuses, and (4) manipulation of the electricity market—leading to a California energy crisis. Only Sherron Watkins, an Enron accountant, was willing to speak out regarding the questionable nature of these practices. In a now-famous memo to then-CEO Kenneth Lay, Watkins warned:

> *I realize that we have had a lot of smart people looking at this and a lot of accountants including AA & Co. [Arthur Andersen] have blessed the accounting treatment. None of that will protect Enron if these transactions are ever disclosed in the bright light of day.*

At WorldCom, Cynthia Cooper, an internal auditor, noted that some of the company's capital expenditures should have been listed on the second-quarter financial statements as expenses. When she mentioned this to both WorldCom's controller and its chief financial officer, she was told to stop what she was doing and to delay the audit until the third quarter (when expensing the transactions would not be noticed). Instead, Cooper informed the board of directors' audit committee. Two weeks later, WorldCom announced that it was reducing earnings by $3.9 billion, the largest restatement in history.

SOURCES: G. Colvin, "Wonder Women of Whistleblowers," *Fortune* (August 12, 2002), p. 56; W. Zellner, "The Deadly Sins of Enron," *Business Week* (October 14, 2002), pp. 26–28; M. J. Mandel, "And the Enron Award Goes to . . . Enron," *Business Week* (May 20, 2002), p. 46.

governance system is *rule-based* or *relationship-based*. Relationship-based countries tend to be less transparent and have a higher degree of corruption than do rule-based countries.[42] See the **Global Issue** feature for an explanation of country governance systems and how they may affect business practices.

Another possible reason for what is often perceived to be unethical behavior lies in differences in values between business people and key stakeholders. Some businesspeople may believe profit maximization is the key goal of their firm, whereas concerned interest groups may have other priorities, such as the hiring of minorities and women or the safety of their neighborhoods. Of the six values measured by the Allport-Vernon-Lindzey Study of Values test (aesthetic, economic, political, religious, social, and theoretical), both U.S. and UK executives consistently score highest on economic and political values and lowest on social and religious ones. This is similar to the value profile of managers from Japan, Korea, India, and Australia, as well as those of U.S. business school students. U.S. Protestant ministers, in contrast, score highest on religious and social values and very low on economic values.[43]

This difference in values can make it difficult for one group of people to understand another's actions. For example, even though some people feel that the advertising of cigarettes and alcoholic drinks (especially to youth) is unethical, the people managing these companies can respond that they are simply offering a product; *"Let the buyer beware"* is a traditional saying in free-market capitalism. They argue that customers in a free market democracy have the right to choose how they spend their money and live their lives. Social progressives may contend that business people working in tobacco, alcoholic beverages, and gambling industries are acting unethically by making and advertising products with potentially dangerous and expensive side effects, such as cancer, alcoholism, and addiction. People working in these industries could respond by asking whether it is ethical for people who don't smoke, drink, or

GLOBAL issue

HOW RULE-BASED AND RELATIONSHIP-BASED GOVERNANCE SYSTEMS AFFECT ETHICAL BEHAVIOR

The developed nations of the world operate under governance systems quite different from those used by developing nations. The developed nations and the business firms within them follow well-recognized rules in their dealings and financial reporting. To the extent that a country's rules force business corporations to publicly disclose in-depth information about the company to potential shareholders and others, that country's financial and legal system is said to be *transparent*. Transparency is said to simplify transactions and reduce the temptation to behave illegally or unethically. Finland, the United Kingdom, Hong Kong, the United States, and Australia have very transparent business climates. The Kurtzman Group, a consulting firm, developed an *opacity index* that measures the risks associated with unclear legal systems, regulations, economic policies, corporate governance standards, and corruption in 48 countries. The countries with the most opaque/least transparent ratings are Indonesia, Venezuela, China, Nigeria, India, Egypt, and Russia.

Developing nations tend to have *relationship-based governance*. Transactions are based on personal and implicit agreements, not on formal contracts enforceable by a court. Information about a business is largely local and private—thus cannot be easily verified by a third party. In contrast, *rule-based governance* relies on publicly verifiable information—the type of information that is typically not available in a developing country. The rule-based system has an infrastructure, based on accounting, auditing, ratings systems, legal cases, and codes, to provide and monitor this information. If present in a developing nation, the infrastructure is not very sophisticated. This is why investing in a developing country is very risky. The relationship-based system in a developing nation is inherently nontransparent due to the local and non-verifiable nature of its information. A business person needs to develop and nurture a wide network of personal relationships. *What* you know is less important than *who* you know.

The investment in time and money needed to build the necessary relationships to conduct business in a developing nation creates a high entry barrier for any newcomers to an industry. Thus, key industries in developing nations tend to be controlled by a small number of companies, usually privately owned, family-controlled conglomerates. Because public information is unreliable and insufficient for decisions, strategic decisions may depend more on a CEO playing golf with the prime minister than with questionable market share data. In a relationship-based system, the culture of the country (and the founder's family) strongly affects corporate culture and business ethics. What is "fair" depends on whether one is a family member, a close friend, a neighbor, or a stranger. Because behavior tends to be less controlled by laws and agreed-upon standards than by tradition, businesspeople from a rule-based developed nation perceive the relationship-based system in a developing nation to be less ethical and more corrupt. According to Larry Smeltzer, ethics professor at Arizona State University: "The lack of openness and predictable business standards drives companies away. Why would you want to do business in, say Libya, where you don't know the rules?"

SOURCES: S. Li, S. H. Park, and S. Li, "The Great Leap Forward: The Transition from Relation-Based Governance to Rule-Based Governance," *Organizational Dynamics*, Vol. 33, No. 1 (2003), pp. 63–78; M. Davids, "Global Standards, Local Problems," *Journal of Business Strategy* (January/February 1999), pp. 38–43; "The Opacity Index," *Economist* (September 18, 2004), p. 106.

gamble to reject another person's right to do so. One example is the recent controversy over the marketing of "alcopops," caffeinated malt beverages containing twice as much alcohol as many beers in the U.S. Critics of Sparks and Tilt call them alcoholic beverages disguised as energy drinks aimed at luring underage drinkers.[44]

Seventy percent of executives representing 111 diverse national and multinational corporations reported that they bend the rules to attain their objectives.[45] The three most common reasons given were:

- Organizational performance required it—74%
- Rules were ambiguous or out of date—70%
- Pressure from others and everyone does it—47%

The financial community's emphasis on short-term earnings performance is a significant pressure for executives to "manage" quarterly earnings. For example, a company achieving its forecasted quarterly earnings figure signals the investment community that its strategy and operations are proceeding as planned. Failing to meet its targeted objective signals that the company is in trouble—thus causing the stock price to fall and shareholders to become worried. Research by Degeorge and Patel involving more than 100,000 quarterly earnings reports revealed that a preponderance (82%) of reported earnings *exactly* matched analysts' expectations or exceeded them by 1%. The disparity between the number of earnings reports that missed estimates by a penny and the number that exceeded them by a penny suggests that executives who risked falling short of forecasts "borrowed" earnings from future quarters.[46]

In explaining why executives and accountants at Enron engaged in unethical and illegal actions, former Enron vice president Sherron Watkins used the "*frogs in boiling water*" analogy. If, for example, one were to toss a frog into a pan of boiling water, according to the folk tale, the frog would quickly jump out. It might be burned, but the frog would survive. However, if one put a frog in a pan of cold water and turned up the heat very slowly, the frog would not sense the increasing heat until it was too lethargic to jump out and would be boiled. According to Watkins:

> *Enron's accounting moved from creative to aggressive, to fraudulent, like the pot of water moving from cool to lukewarm to boiling; those involved with the creative transactions soon found themselves working on the aggressive transactions and were finally in the uncomfortable situation of working on fraudulent deals.*[47]

Moral Relativism

Some people justify their seemingly unethical positions by arguing that there is no one absolute code of ethics and that morality is relative. Simply put, **moral relativism** claims that morality is relative to some personal, social, or cultural standard and that there is no method for deciding whether one decision is better than another.

At one time or another, most managers have probably used one of the four types of moral relativism—naïve, role, social group, or cultural—to justify questionable behavior.[48]

Naïve relativism: Based on the belief that all moral decisions are deeply personal and that individuals have the right to run their own lives, adherents of moral relativism argue that each person should be allowed to interpret situations and act on his or her own moral values. This is not so much a belief as it is an excuse for not having a belief or is a common excuse for not taking action when observing others lying or cheating.

Role relativism: Based on the belief that social roles carry with them certain obligations to that role, adherents of role relativism argue that a manager in charge of a work unit must put aside his or her personal beliefs and do instead what the role requires, that is, act in the best interests of the unit. Blindly following orders was a common excuse provided by Nazi war criminals after World War II.

Social group relativism: Based on a belief that morality is simply a matter of following the norms of an individual's peer group, social group relativism argues that a decision is considered legitimate if it is common practice, regardless of other considerations ("everyone's doing it"). A real danger in embracing this view is that the person may incorrectly believe that a certain action is commonly accepted practice in an industry when it is not.

Cultural relativism: Based on the belief that morality is relative to a particular culture, society, or community, adherents of cultural relativism argue that people should understand the practices of other societies, but not judge them. This view not only suggests that one should not criticize another culture's norms and customs, but also that it is acceptable to personally follow these norms and customs ("When in Rome, do as the Romans do.").

Although these arguments make some sense, moral relativism could enable a person to justify almost any sort of decision or action, so long as it is not declared illegal.

Kohlberg's Levels of Moral Development

Another reason why some business people might be seen as unethical is that they may have no well-developed personal sense of ethics. A person's ethical behavior is affected by his or her level of moral development, certain personality variables, and such situational factors as the job itself, the supervisor, and the organizational culture.[49] Kohlberg proposes that a person progresses through three **levels of moral development.**[50] Similar in some ways to Maslow's hierarchy of needs, in Kohlberg's system, the individual moves from total self-centeredness to a concern for universal values. Kohlberg's three levels are as follows:

1. **The preconventional level:** This level is characterized by a concern for self. Small children and others who have not progressed beyond this stage evaluate behaviors on the basis of personal interest—avoiding punishment or quid pro quo.
2. **The conventional level:** This level is characterized by considerations of society's laws and norms. Actions are justified by an external code of conduct.
3. **The principled level:** This level is characterized by a person's adherence to an internal moral code. An individual at this level looks beyond norms or laws to find universal values or principles.

Kohlberg places most people in the conventional level, with fewer than 20% of U.S. adults in the principled level of development.[51] Research appears to support Kohlberg's concept. For example, one study found that individuals higher in cognitive moral development, lower in Machiavellianism, with a more internal locus of control, a less-relativistic moral philosophy, and higher job satisfaction are less likely to plan and enact unethical choices.[52]

ENCOURAGING ETHICAL BEHAVIOR

Following Carroll's work, if business people do not act ethically, government will be forced to pass laws regulating their actions—and usually increasing their costs. For self-interest, if for no other reason, managers should be more ethical in their decision making. One way to do that is by developing codes of ethics. Another is by providing guidelines for ethical behavior.

Codes of Ethics

A **code of ethics** specifies how an organization expects its employees to behave while on the job. Developing codes of ethics can be a useful way to promote ethical behavior, especially for people who are operating at Kohlberg's conventional level of moral development. Such codes are currently being used by more than half of U.S. business corporations. A code of ethics (1) clarifies company expectations of employee conduct in various situations and (2) makes clear that the company expects its people to recognize the ethical dimensions in decisions and actions.[53]

Various studies indicate that an increasing number of companies are developing codes of ethics and implementing ethics training workshops and seminars. However, research also indicates that when faced with a question of ethics, managers tend to ignore codes of ethics and try to solve dilemmas on their own.[54] To combat this tendency, the management of a company that wants to improve its employees' ethical behavior should not only develop a comprehensive code of ethics but also communicate the code in its training programs, in its performance appraisal system, policies and procedures, and through its own actions.[55] It may even include key values in its values and mission statements. According to a 2004 survey of CEOs by the Business Roundtable Institute for Corporate Ethics, 74% of CEOs confirmed that their companies

had made changes within the previous two years in how they handled or reported ethics issues. Specific changes reported were:

- Enhanced internal reporting and communications—33%
- Ethics hotlines—17%
- Improved compliance procedures—12%
- Greater oversight by the board of directors—10%[56]

In addition, U.S. corporations have attempted to support **whistle-blowers,** those employees who report illegal or unethical behavior on the part of others. The U.S. False Claims Act gives whistle-blowers 15% to 30% of any damages recovered in cases where the government is defrauded. Even though the Sarbanes-Oxley Act forbids firms from retaliating against anyone reporting wrongdoing, 82% of those who uncovered fraud from 1996 to 2004 reported being ostracized, demoted, or pressured to quit.[57]

Corporations appear to benefit from well-conceived and implemented ethics programs. For example, companies with strong ethical cultures and enforced codes of conduct have fewer unethical choices available to employees—thus fewer temptations.[58] A study by the Open Compliance and Ethics Group found that no company with an ethics program in place for 10 years or more experienced "reputational damage" in the last five years.[59] Some of the companies identified in surveys as having strong moral cultures are Canon, Hewlett-Packard, Johnson & Johnson, Levi Strauss, Medtronic, Motorola, Newman's Own, Patagonia, S. C. Johnson, Shorebank, Smucker, and Sony.[60]

A corporation's management should consider establishing and enforcing a code of ethical behavior for those companies with which it does business—especially if it outsources its manufacturing to a company in another country. For example, Gap International, one of American's largest fashion retailers, developed one of the most rigorous codes of conduct for its suppliers. Its suppliers must comply with all child-labor laws on hiring, working hours, overtime, and working conditions. Workers must be at least 14 years of age. Rather than simply canceling business with suppliers using child labor, Gap requires suppliers to stop using child workers and to provide them with schooling instead, while continuing to pay them regularly and guaranteeing them a job once they reach legal age. In one year, Gap canceled contracts with 23 factories that did not meet its standards.[61]

Gap's experience, however, may be unusual. Recent surveys of over one hundred companies in the Global 2000 uncovered that 64% have some code of conduct that regulates supplier conduct, but only 40% require suppliers to actually take any action with respect to the code, such as disseminating it to employees, offering training, certifying compliance, or even reading or acknowledging receipt of the code.[62]

It is important to note that having a code of ethics for suppliers does not prevent harm to a corporation's reputation if one of its offshore suppliers is able to conceal abuses. Numerous Chinese factories, for example, keep double sets of books to fool auditors and distribute scripts for employees to recite if they are questioned. Consultants have found new business helping Chinese companies evade audits.[63]

Guidelines for Ethical Behavior

Ethics is defined as the consensually accepted standards of behavior for an occupation, a trade, or a profession. *Morality,* in contrast, is the precepts of personal behavior based on religious or philosophical grounds. *Law* refers to formal codes that permit or forbid certain behaviors and may or may not enforce ethics or morality.[64] Given these definitions, how do we arrive at a comprehensive statement of ethics to use in making decisions in a specific occupation, trade, or profession? A starting point for such a code of ethics is to consider the three basic approaches to ethical behavior:[65]

1. **Utilitarian approach:** The **utilitarian approach** proposes that actions and plans should be judged by their consequences. People should therefore behave in a way that will produce the greatest benefit to society and produce the least harm or the lowest cost. A problem with this approach is the difficulty in recognizing all the benefits and the costs of any particular decision. Research reveals that only the stakeholders who have the most *power* (ability to affect the company), *legitimacy* (legal or moral claim on company resources), and *urgency* (demand for immediate attention) are given priority by CEOs.[66] It is therefore likely that only the most obvious stakeholders will be considered, while others are ignored.
2. **Individual rights approach:** The **individual rights approach** proposes that human beings have certain fundamental rights that should be respected in all decisions. A particular decision or behavior should be avoided if it interferes with the rights of others. A problem with this approach is in defining "fundamental rights." The U.S. Constitution includes a Bill of Rights that may or may not be accepted throughout the world. The approach can also encourage selfish behavior when a person defines a personal need or want as a "right."
3. **Justice approach:** The **justice approach** proposes that decision makers be equitable, fair, and impartial in the distribution of costs and benefits to individuals and groups. It follows the principles of *distributive justice* (people who are similar on relevant dimensions such as job seniority should be treated in the same way) and *fairness* (liberty should be equal for all persons). The justice approach can also include the concepts of *retributive justice* (punishment should be proportional to the offense) and *compensatory justice* (wrongs should be compensated in proportion to the offense). Affirmative action issues such as reverse discrimination are examples of conflicts between distributive and compensatory justice.

Cavanagh proposes that we solve ethical problems by asking the following three questions regarding an act or a decision:

1. **Utility:** Does it optimize the satisfactions of all stakeholders?
2. **Rights:** Does it respect the rights of the individuals involved?
3. **Justice:** Is it consistent with the canons of justice?

For example, is padding an expense account ethical? Using the utility criterion, this action increases the company's costs and thus does not optimize benefits for shareholders or customers. Using the rights approach, a person has no right to the money (otherwise, we wouldn't call it "padding"). Using the justice criterion, salary and commissions constitute ordinary compensation, but expense accounts compensate a person only for expenses incurred in doing his or her job—expenses that the person would not normally incur except in doing the job.[67]

Another approach to resolving ethical dilemmas is by applying the logic of the philosopher Immanuel Kant. Kant presents two principles (called **categorical imperatives**) to guide our actions:

1. A person's action is ethical only if that person is willing for that same action to be taken by everyone who is in a similar situation. This is the same as the Golden Rule: Treat others as you would like them to treat you. For example, padding an expense account would be considered ethical if the person were also willing for everyone else to do the same if they were the boss. Because it is very doubtful that any manager would be pleased with expense account padding, the action must be considered unethical.
2. A person should never treat another human being simply as a means but always as an end. This means that an action is morally wrong for a person if that person uses others merely as means for advancing his or her own interests. To be moral, the act should not restrict other people's actions so that they are disadvantaged in some way.[68]

End of Chapter SUMMARY

In his book *Defining Moments*, Joseph Badaracco states that most ethics problems deal with "right versus right" problems in which neither choice is wrong. These are what he calls "dirty hands problems" in which a person has to deal with very specific situations that are covered only vaguely in corporate credos or mission statements. For example, many mission statements endorse fairness but fail to define the term. At the personal level, *fairness* could mean playing by the rules of the game, following basic morality, treating everyone alike and not playing favorites, treating others as you would want to be treated, being sensitive to individual needs, providing equal opportunity for everyone, or creating a level playing field for the disadvantaged. According to Badaracco, codes of ethics are not always helpful because they tend to emphasize problems of misconduct and wrongdoing, not a choice between two acceptable alternatives, such as keeping an inefficient plant operating for the good of the community or closing the plant and relocating to a more efficient location to lower costs.[69]

This chapter provides a framework for understanding the social responsibilities of a business corporation. Following Carroll, it proposes that a manager should consider not only the economic and legal responsibilities of a firm but also its ethical and discretionary responsibilities. It also provides a method for making ethical choices, whether they are right versus right or some combination of right and wrong. It is important to consider Cavanaugh's questions using the three approaches of utilitarian, rights, and justice plus Kant's categorical imperatives when making a strategic decision. A corporation should try to move from Kohlberg's conventional to a principled level of ethical development. If nothing else, the frameworks should contribute to well-reasoned strategic decisions that a person can defend when interviewed by hostile media or questioned in a court room.

ECO-BITS

- An Australian nut orchard converts the shells of old Macintosh computers into houses for pest-eating birds.
- Nike gathers old athletic shoes and turns them into raw material for "sports surfaces" like tennis courts and running tracks.
- The British company Ecopods sells stylish coffins made from hardened recycled paper.
- It takes three months for a recycled aluminum can to return to the supermarket shelf in reincarnated form.[70]

DISCUSSION QUESTIONS

1. What is the relationship between corporate governance and social responsibility?
2. What is your opinion of Gap International's having a code of conduct for its suppliers? What would Milton Friedman say? Contrast his view with Archie Carroll's view.
3. Does a company have to act selflessly to be considered socially responsible? For example, when building a new plant, a corporation voluntarily invested in additional equipment that enabled it to reduce its pollution emissions beyond any current laws. Knowing that it would be very expensive for its competitors to do the same, the firm lobbied the government to make pollution regulations more restrictive on the entire industry. Is this company socially responsible? Were its managers acting ethically?
4. Are people living in a relationship-based governance system likely to be unethical in business dealings?
5. Given that people rarely use a company's code of ethics to guide their decision making, what good are the codes?

STRATEGIC PRACTICE EXERCISE

It is 1982. Zombie Savings and Loan is in trouble. This is a time when many savings and loans (S&Ls) are in financial difficulty. Zombie holds many 30-year mortgages at low fixed-interest rates in its loan portfolio. Interest rates have risen significantly, and the Deregulation Act of 1980 has given Zombie and other S&Ls the right to make business loans and hold up to 20% of its assets as such. Because interest rates in general have risen, but the rate that Zombie receives on its old mortgages has not, Zombie must now pay out higher interest rates to its deposit customers or see them leave, and it has negative cash flow until rates fall below the rates in its mortgage portfolio or Zombie itself fails.

In present value terms, Zombie is insolvent, but the accounting rules of the time do not require marking assets to market, so Zombie is allowed to continue to operate and is faced with two choices: It can wait and hope interest rates fall before it is declared insolvent and is closed down, or it can raise fresh (insured) deposits and make risky loans that have high interest rates. Risky loans promise high payoffs (if they are repaid), but the probability of loss to Zombie and being closed later with greater loss to the Federal Savings & Loan Insurance Corporation (FSLIC) is high. Zombie stays in business if its gamble pays off, and it loses no more than it has already lost if the gamble does not pay off. Indeed, if not closed, Zombie will raise increasingly greater new deposits and make more risky loans until it either wins or is shut down by the regulators.

Waiting for lower interest rates and accepting early closure if lower rates do not arrive is certainly in the best interest of the FSLIC and of the taxpayers, but the manager of Zombie has more immediate responsibilities, such as employees' jobs, mortgage customers, depositors, the local neighborhood, and his or her job. As a typical S&L, Zombie's depositors are its shareholders and vote according to how much money they have in savings accounts with Zombie. If Zombie closes, depositors may lose some, but not all of their money, because their deposits are insured by the FSLIC. There is no other provider of home mortgages in the immediate area. What should the manager do?

SOURCE: Adapted from D. W. Swanton, "Teaching Students the Nature of Moral Hazard: An Ethical Component for Finance Classes," paper presented to the annual meeting of the *Academy of Finance*, Chicago (March 13, 2003). Reprinted with permission.

KEY TERMS

categorical imperatives (p. 85)
code of ethics (p. 83)
ethics (p. 84)
individual rights approach (p. 85)
justice approach (p. 85)
law (p. 84)
levels of moral development (p. 83)
morality (p. 84)
moral relativism (p. 82)
social responsibility (p. 72)
stakeholder analysis (p. 76)
stakeholders (p. 75)
utilitarian approach (p. 85)
whistle-blowers (p. 84)

NOTES

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Ending Case for Part One

BLOOD BANANAS

Every company hates to be blackmailed, but that was exactly what was happening to one of America's largest fruit growing and processing companies, Chiquita Brands. Carlos Castaño, leader of the United Self Defense Forces of Columbia (AUC), a Colombian paramilitary organization, had just proposed that it would be in the best interests of Chiquita Brands and its subsidiary in Colombia, Banadex, to pay the AUC a few thousand dollars per month for "security" services. The security services were little more than protection from the AUC itself. Unfortunately, the local law enforcement agencies as well as the U.S. government were in no position to offer legitimate protection from paramilitary groups like the AUC. Chiquita was forced to decide whether to pay the AUC for protection or risk the lives of Chiquita employees in Colombia.

Chiquita Brands International Inc., headquartered in Cincinnati, Ohio, was a leading international marketer and distributor of high-quality fresh produce that was sold under the Chiquita® premium brand and related trademarks. The company was one of the largest banana producers in the world and a major supplier of bananas in Europe and North America. The company had revenues of approximately $4.5 billion and employed about 25,000 people in 70 countries in 2006.

Chiquita Brands, formerly United Brands and United Fruit, had been operating fruit plantations in Colombia for nearly 100 years. Chiquita's Banadex was responsible for 4,400 direct and an additional 8,000 indirect jobs in Colombia, jobs that were almost entirely performed by local (Colombian) workers. The company "contributed almost $70 million annually to the Colombian economy in the form of capital expenditures, payroll, taxes, social security, pensions, and local purchases of goods and services." Banadex was responsible for managing Chiquita's extensive plantation holding and was Chiquita's most profitable international operation.

By the 1990s, Colombia had become a very violent country. Kidnappings and murders of wealthy Colombians and foreigners had become commonplace. The U.S. State Department had issued several advisories warning U.S. citizens about the dangers of travel to the country. In 1997, Carlos Castaño, leader of the AUC, met with senior officials of Banadex and offered to provide security services to the Banadex workers and property in Colombia. The AUC, often described as a "death squad," was one of the most violent, paramilitary organizations that existed in Colombia. Estimated by the U.S. State Department to number between 8,000 and 11,000 members, their activities included assassinations, guerrilla warfare, and drug trafficking. So far the AUC had not been designated a Foreign Terrorist Organization by the U.S. State Department, so it was not illegal to do business with the AUC. The implication of the offer for Banadex employees was obvious. Extortion or not, the implication of non-participation by Banadex would put employees at serious risk.

The options for Chiquita were straightforward: agree to pay, refuse to pay, or exit the country. The ramifications of any of the actions, however, were not pleasant.

Agree to Pay: If Chiquita agreed to pay for "protection" they might forestall killings and kidnappings; however, they would be financing a group of terrorists. The money it paid would be used to further the activities of AUC.

Refuse to Pay: If Chiquita chose to reject the offer of "protection" from Castaño, then there was the real likelihood that Banadex employees would be kidnapped and/or executed. There was ample evidence of the brutality of the AUC and similar organizations currently operating in Colombia. While a legitimate security company might be found to protect the plantations and employees, the cost to hire sufficient men to withstand a force of 8,000–11,000 paramilitary fighters would be inordinately expensive. Only governments had the strength to mount such a protective service and neither the U.S. nor Colombian governments were willing to support such an effort. Furthermore, it was unlikely that the Colombian government would welcome a mercenary force hired by Chiquita into the country.

Exit the Country: If the decision was made to abandon the plantations in Colombia what would happen to

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the 12,000 individuals whose livelihoods depended upon the work or workers on the plantation? Contributing $70 million annually to the economy, a rapid exit would represent a significant loss to the Colombian people. Further, Banadex exports represented a significant portion of the bananas sold by Chiquita brands. The loss of this supply would not only affect Chiquita Brands' profitability and shareholder value but also the profitability of numerous Chiquita distributors around the world.

Study Question

1. What should Chiquita do?

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PART 2

Scanning the Environment

CHAPTER 4

environmental scanning and Industry Analysis

The Arctic is undergoing an extraordinary transformation—a transformation that will have global impact not only on wildlife, but upon many countries and a number of industries. Some of the most significant environmental changes are retreating sea ice, melting glaciers, thawing permafrost, increasing coastal erosion, and shifting vegetation zones. The average temperature of the Arctic has risen at twice the rate of the rest of the planet. According to *Impacts of a Warming Arctic: Arctic Climate Impact Assessment*, a 2004 report by the eight-nation Arctic Council, the melting of the area's highly reflective snow and sea ice is uncovering darker land and ocean surfaces, further increasing the absorption of the sun's heat. Reductions in Arctic sea ice will drastically shrink marine habitats for polar bears, ice seals, and some seabirds. The warming of the tundra will likely boost greenhouse gases by releasing long-stored quantities of methane and carbon dioxide.

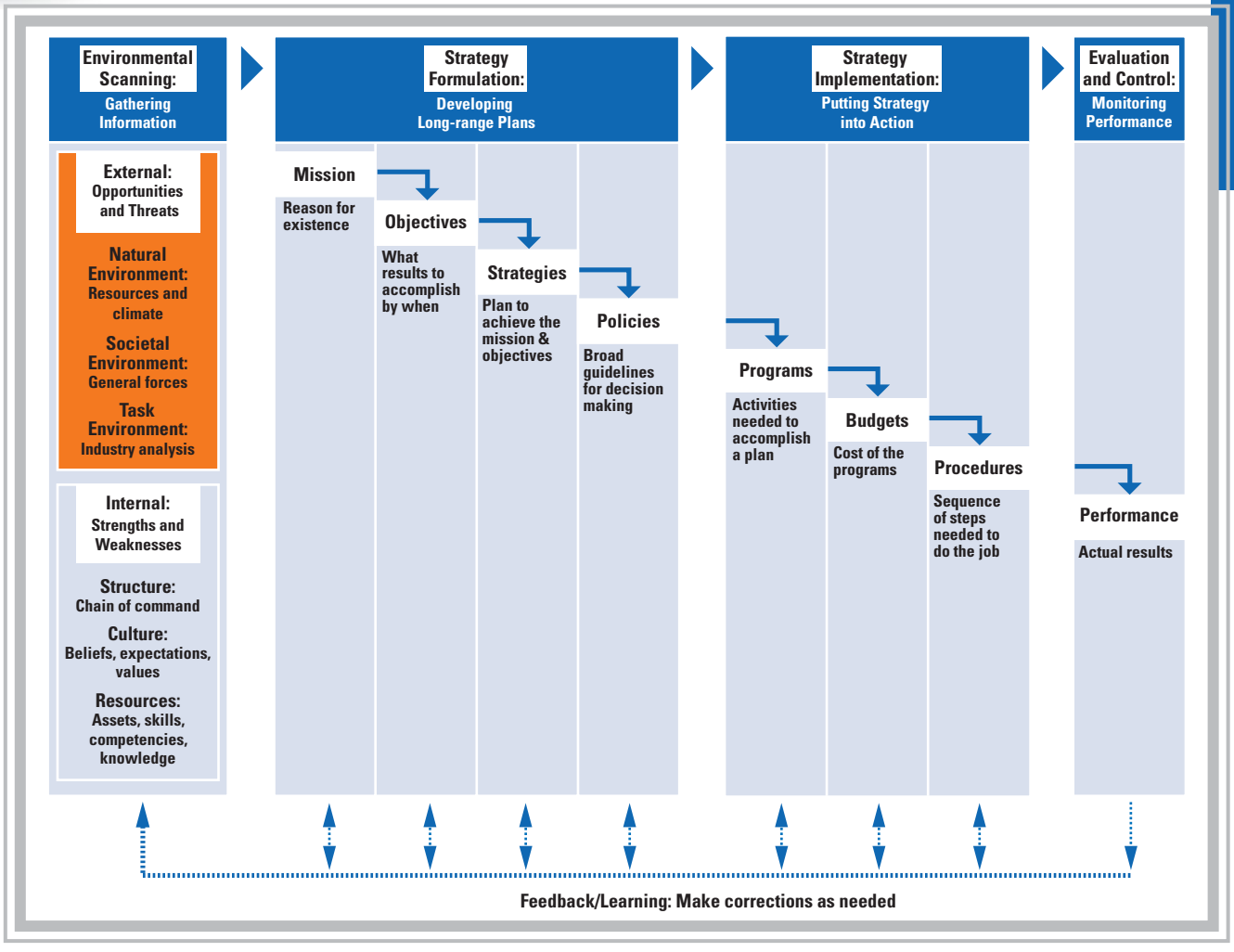
In addition to containing a large percentage of the world's water as ice, the Arctic is a large storehouse of natural resources. Given that the Arctic Ocean could be ice-free in the summer by 2040, countries bordering the Arctic are already positioning themselves for exploitation of these resources. Lawson Brigham, Alaska Office Director of the U.S. Arctic Research Commission and a former chief of strategic planning for the U.S. Coast Guard, examined how regional warming will affect transportation systems, resource development, indigenous Arctic peoples, regional environmental degradation and protection schemes, and overall geopolitical issues. From this, he proposes four possible scenarios for the Arctic in 2040:

1. **Globalized frontier:** In this scenario, the Arctic by 2040 has become an integral component of the global economic system, but is itself a semi-lawless frontier with participants jockeying for control. The summer sea ice has completely disappeared for a two-week period, allowing greater marine access and commercial shipping throughout the area. The famous "Northwest Passage" dreamed by 16th century navigators is now a reality. Rising prices for oil, natural gas, nickel, copper, zinc, and freshwater in conjunction with an easily accessible and less-harsh climate have made Arctic natural resource exploitation economically viable. Even though overfishing has reduced fish stocks, Arctic tourism is flourishing. By now, well-worn oil and gas pipelines in western Siberia and Alaska are experiencing recurring serious

Learning Objectives

After reading this chapter, you should be able to:

- Recognize aspects of an organization's environment that can influence its long-term decisions
- Identify the aspects of an organization's environment that are most strategically important
- Conduct an industry analysis to understand the competitive forces that influence the intensity of rivalry within an industry
- Understand how industry maturity affects industry competitive forces
- Categorize international industries based on their pressures for coordination and local responsiveness
- Construct strategic group maps to assess the competitive positions of firms in an industry
- Identify key success factors and develop an industry matrix
- Use publicly available information to conduct competitive intelligence
- Know how to develop an industry scenario
- Be able to construct an EFAS table that summarizes external environmental factors



spills. By 2020, Canada, Denmark (Greenland), Norway, Russia, and the United States had asserted their sovereignty over sea bed resources beyond 200 nautical miles—leaving only two small regions in the central Arctic Ocean under international jurisdiction. Environmental concerns that once fostered polar cooperation have been replaced by economic and political interests. The protection, development, and governance of the Svalbard Islands became a problem when Russia refused to recognize Norway's 200-nautical mile exclusive economic zone around the islands. Issues regarding freedom of navigation and commercial access rights are highly contentious. The eight permanent members of the Arctic Council have increasingly excluded outside participation in the Council's deliberations.

2. **Adaptive frontier:** In this scenario, the Arctic in 2040 is being drawn much more slowly into the global economy. The area is viewed as an international resource. Competition among the Arctic countries for control of the region's resources never grew beyond a low level and the region is the scene of international cooperation among many international stakeholders. The indigenous peoples throughout the area have organized and now have significant influence over decisions relating to regional environmental protection and economic development. The exploitation of Arctic oil and gas is restricted to the few key areas that are most cost-competitive. Air and water transportation systems flourish throughout the area. Commercially viable fishing has continued, thanks to stringent harvesting quotas and other bilateral agreements. The Arctic Council is a proactive forum resolving several disputes and engaging the indigenous peoples in all deliberations. Nevertheless, the impact of global warming on the Arctic is widespread and serious. Contingency planning for manmade and natural emergencies is advanced and well coordinated. Sustainable development is widely supported by most stakeholders. The Arctic region has become a model for habitat protection. Arctic national parks have expanded modestly and adapted to deal with increased tourism.
3. **Fortress frontier:** In this scenario, widespread resource exploitation and increased international tension exist throughout the Arctic. The region is viewed by much of the global community as a storehouse of natural resources that is being jealously guarded by a handful of wealthy circumpolar nations. Although the Arctic is part of the global economic system, any linkage is controlled by the most powerful Arctic countries for their own benefit. By 2040, the Arctic is undergoing extreme environmental stress, as global warming continues unabated. Many indigenous peoples have been displaced from their traditional homelands due to extreme environmental events. Illegal immigration becomes an issue in many subarctic regions. Although air and marine transportation routes are open, foreign access has been periodically suspended for political or security reasons. Russia and Canada, in particular, continue to tightly control marine access through the Northern Sea Route and Northwest Passage. Fishing rights have been suspended to all but the Arctic countries. Oil and gas exploration and production has intensified throughout the Arctic. The Svalbard Islands, claimed

by Norway, have been a source of potential conflict over access to living and nonliving resources. Norway, Russia, and the United States have increased military forces in the region. Rather than dealing with sustainable development, the Arctic Council focuses on economic and security concerns, such as illegal immigrants and controlling the flow of exports from the Arctic consortium. Early in the 21st century, the five countries bordering the Arctic declared their sovereignty over resources beyond 200 nautical miles to the edge of the continental shelf extensions. By 2030, the Arctic Council unilaterally took jurisdiction over the two small regions that remained within international jurisdiction. Arctic tourism thrives, since many other traditional destinations are experiencing turmoil and a shortage of necessities.

4. **Equitable frontier:** In this scenario, the Arctic is integrated with the global economic system by 2040, but international concern for sustainable development has slowed the region's economic development. Mutual respect and cooperation among the circumpolar nations allows for the development of a respected Arctic governance system. Even though the world is working hard to reduce greenhouse gas emissions, the Arctic continues to warm. Transport user fees and other eco-taxes are used to support endangered wildlife and impacted indigenous communities. The growth of the Northern Sea Route and Northwest Passage has enabled significant efficiencies in commercial shipping. Canada and Russia have maintained stringent marine regulations that emphasize environmental protection. Despite differences over freedom of navigation, the United States, Canada, and Russia have negotiated an agreement that allows a seamless voyage around Alaska and through the routes under a uniform set of operational procedures. The Arctic Council has created regional disaster teams to respond to maritime and other emergencies. Boundary disputes have been resolved and fishing rights have been allocated to various nations. The University of the Arctic has brought quality online education to easy reach of all northern citizens. The Arctic Council has brokered an agreement to allow 30,000 environmental refugees to settle in subarctic territories. Oil exploration and production in the Arctic has slowed considerably. Arctic tourism continues its steady growth, prompting national and regional parliaments to establish additional wilderness lands funded by tourist fees. There is low military presence in the region, thanks to the diplomatic efforts of the Arctic Council.

The Arctic is a complex, but relatively small region. These four scenarios suggest how climate change combined with a growing need for natural resources might impact this region and the world.[1]

- Which of the four preceding scenarios is most likely?
- Which industries are likely to be affected (either positively or negatively) by the warming of the Arctic?
- If in an affected industry, how could a business corporation prepare for each of these scenarios?

A changing environment can help as well as hurt a company. Many pioneering companies have gone out of business because of their failure to adapt to environmental change or, even worse, because of their failure to create change. For example, Baldwin Locomotive, the major manufacturer of steam locomotives, was very slow in making the switch to diesel locomotives. General Electric and General Motors soon dominated the diesel locomotive business and Baldwin went out of business. The dominant manufacturers of vacuum tubes failed to make the change to transistors and consequently lost this market. Eastman Kodak, the pioneer and market leader of chemical-based film photography, continues to struggle with its transition to the newer digital technology. Failure to adapt is, however, only one side of the coin. The aforementioned Arctic warming example shows how a changing environment can create new opportunities at the same time it destroys old ones. The lesson is simple: To be successful over time, an organization needs to be in tune with its external environment. There must be a strategic fit between what the environment wants and what the corporation has to offer, as well as between what the corporation needs and what the environment can provide.

Current predictions are that the environment for all organizations will become even more uncertain with every passing year. What is **environmental uncertainty**? It is the *degree of complexity* plus the *degree of change* that exists in an organization's external environment. As more and more markets become global, the number of factors a company must consider in any decision becomes huge and much more complex. With new technologies being discovered every year, markets change and products must change with them.

On the one hand, environmental uncertainty is a threat to strategic managers because it hampers their ability to develop long-range plans and to make strategic decisions to keep the corporation in equilibrium with its external environment. On the other hand, environmental uncertainty is an opportunity because it creates a new playing field in which creativity and innovation can play a major part in strategic decisions.

4.1 Environmental Scanning

Before an organization can begin strategy formulation, it must scan the external environment to identify possible opportunities and threats and its internal environment for strengths and weaknesses. **Environmental scanning** is the monitoring, evaluation, and dissemination of information from the external and internal environments to key people within the corporation. A corporation uses this tool to avoid strategic surprise and to ensure its long-term health. Research has found a positive relationship between environmental scanning and profits.[2] Approximately 70% of executives around the world state that global social, environmental, and business trends are increasingly important to corporate strategy, according to a 2008 survey by McKinsey & Company.[3]

IDENTIFYING EXTERNAL ENVIRONMENTAL VARIABLES

In undertaking environmental scanning, strategic managers must first be aware of the many variables within a corporation's natural, societal, and task environments (see **Figure 1–3**). The

natural environment includes physical resources, wildlife, and climate that are an inherent part of existence on Earth. These factors form an ecological system of interrelated life. The **societal environment** is mankind's social system that includes general forces that do not directly touch on the short-run activities of the organization that can, and often do, influence its long-run decisions. These factors affect multiple industries and are as follows:

- **Economic forces** that regulate the exchange of materials, money, energy, and information.
- **Technological forces** that generate problem-solving inventions.
- **Political–legal forces** that allocate power and provide constraining and protecting laws and regulations.
- **Sociocultural forces** that regulate the values, mores, and customs of society.

The **task environment** includes those elements or groups that directly affect a corporation and, in turn, are affected by it. These are governments, local communities, suppliers, competitors, customers, creditors, employees/labor unions, special-interest groups, and trade associations. A corporation's task environment is typically the industry within which the firm operates. **Industry analysis** (popularized by Michael Porter) refers to an in-depth examination of key factors within a corporation's task environment. The natural, societal, and task environments must be monitored to detect the strategic factors that are likely in the future to have a strong impact on corporate success or failure. Changes in the natural environment usually affect a business corporation first through its impact on the societal environment in terms of resource availability and costs and then upon the task environment in terms of the growth or decline of particular industries.

Scanning the Natural Environment

The natural environment includes physical resources, wildlife, and climate that are an inherent part of existence on Earth. Until the 20th century, the natural environment was generally perceived by business people to be a given—something to exploit, not conserve. It was viewed as a free resource, something to be taken or fought over, like arable land, diamond mines, deep water harbors, or fresh water. Once they were controlled by a person or entity, these resources were considered assets and thus valued as part of the general economic system—a resource to be bought, sold, or sometimes shared. Side effects, such as pollution, were considered to be *externalities*, costs not included in a business firm's accounting system, but felt by others. Eventually these externalities were identified by governments, which passed regulations to force business corporations to deal with the side effects of their activities.

The concept of sustainability argues that a firm's ability to continuously renew itself for long-term success and survival is dependent not only upon the greater economic and social system of which it is a part, but also upon the natural ecosystem in which the firm is embedded.[4] A business corporation must thus scan the natural environment for factors that might previously have been taken for granted, such as the availability of fresh water and clean air. Global warming means that aspects of the natural environment, such as sea level, weather, and climate, are becoming increasingly uncertain and difficult to predict. Management must therefore scan not only the natural environment for possible strategic factors, but also include in its strategic decision-making processes the impact of its activities upon the natural environment. In a world concerned with global warming, a company should measure and reduce its *carbon footprint*—the amount of greenhouse gases it is emitting into the air. Research reveals that scanning the market for environmental issues is positively related to firm performance because it helps management identify opportunities to fulfill future market demand based upon environmentally friendly products or processes.[5] See the **Environmental Sustainability Issue** feature to learn how individuals can also measure and shrink their personal carbon footprints.

ENVIRONMENTAL sustainability issue

MEASURING AND SHRINKING YOUR PERSONAL CARBON FOOTPRINT

As people become more "green," that is more conscious of environmental sustainability, they wonder what they can do as individuals to reduce the emission of greenhouse gases. This is an important issue given that a typical American produces more than 20 tons of carbon dioxide annually—a very large carbon footprint. Even a homeless American has a carbon footprint of 8.5 tons, more than twice the global average! The first problem for concerned individuals is finding a way to measure the size of their own carbon footprint. The second problem is developing feasible programs to reduce that footprint in some meaningful way.

The Web site *carbonrally.com* solves these problems by presenting competitive environmental challenges and keeping score by translating green actions into pounds of carbon dioxide averted. For instance, cutting the time of a daily shower by two minutes for a month reduces CO_2 emissions by 15.3 pounds. According to Kelsey Schroeder, who has logged savings of more than 1,000 pounds of emissions, "This has been a great motivational technique. We just want to keep going and see if we can do better."

How does Carbonrally calculate someone's carbon shoe size? Since everything a person does that is powered by fossil fuels has a carbon dioxide cost, many activities have the potential of being counted. Commuting in a gasoline powered car has obvious carbon costs, but so does eating a hamburger. Since livestock are responsible for an estimated 18% of global carbon emissions, eating a hamburger results in carbon emissions by the consumer. Something as small as an iPod adds to a person's carbon footprint due not only to the energy used to produce and transport the product, but also to the energy used to charge it over its lifetime—approximately 68 pounds of CO_2. Both the Nature Conservancy and the U.S. Environmental Protection Agency provide ways to measure an individual carbon footprint. The EPA even offers a carbon calculator on its Web site, epa.gov.

Carbonrally offers concrete ways to start cutting carbon emissions. One 2008 contest challenged people to avoid bottled soda, tea, and sports drinks for a month for an average individual savings of 25.7 pounds of CO_2.

Other challenges were using a clothesline to dry one laundry load a week, unplugging computers every night for one month, and using a personal cup for coffee instead of using a disposable cup. By the end of 2008, nearly 15,000 individuals had completed a challenge, effectively reducing over 1,622.57 tons of CO_2.

Given that global carbon dioxide emissions total more than 28 billion tons annually, one person's reductions can seem very small. Why bother? Carbonrally might respond that the best way to change the world is one person at a time.

SOURCES: B. Walsh and T. Sharples, "Sizing Up Carbon Footprints," *Time* (May 26, 2008), pp. 53–55 and www.carbonrally.com.

Scanning the Societal Environment: STEEP Analysis

The number of possible strategic factors in the societal environment is very high. The number becomes enormous when we realize that, generally speaking, each country in the world can be represented by its own unique set of societal forces—some of which are very similar to those of neighboring countries and some of which are very different.

For example, even though Korea and China share Asia's Pacific Rim area with Thailand, Taiwan, and Hong Kong (sharing many similar cultural values), they have very different views about the role of business in society. It is generally believed in Korea and China (and to a lesser extent in Japan) that the role of business is primarily to contribute to national development; however in Hong Kong, Taiwan, and Thailand (and to a lesser extent in the Philippines, Indonesia, Singapore, and Malaysia), the role of business is primarily to make profits for the shareholders.[6] Such differences may translate into different trade regulations and varying difficulty in the *repatriation of profits* (the transfer of profits from a foreign subsidiary to a corporation's headquarters) from one group of Pacific Rim countries to another.

STEEP Analysis: Monitoring Trends in the Societal and Natural Environments. As shown in **Table 4–1**, large corporations categorize the societal environment in any one geographic region into four areas and focus their scanning in each area on trends that have corporatewide relevance. By including trends from the natural environment, this scanning can be called **STEEP Analysis**, the scanning of Sociocultural, Technological, Economic, Ecological, and Political-legal environmental forces.[7] (It may also be called *PESTEL Analysis* for Political, Economic, Sociocultural, Technological, Ecological, and Legal forces.) Obviously, trends in any one area may be very important to firms in one industry but of lesser importance to firms in other industries.

Trends in the *economic* part of the societal environment can have an obvious impact on business activity. For example, an increase in interest rates means fewer sales of major home appliances. Why? A rising interest rate tends to be reflected in higher mortgage rates. Because higher mortgage rates increase the cost of buying a house, the demand for new and used houses tends to fall. Because most major home appliances are sold when people change houses, a reduction in house sales soon translates into a decline in sales of refrigerators, stoves, and dishwashers and reduced profits for everyone in the appliance industry. Changes in the price of oil have a similar impact upon multiple industries, from packaging and automobiles to hospitality and shipping.

The rapid economic development of Brazil, Russia, India, and China (often called the *BRIC* countries) is having a major impact on the rest of the world. By 2007, China had become the world's second-largest economy according to the World Bank. With India graduating more English-speaking scientists, engineers, and technicians than all other nations combined, it has become the primary location for the outsourcing of services, computer software, and telecommunications.[8] Eastern Europe has become a major manufacturing supplier to the European Union countries. According to the International Monetary Fund, emerging markets make up less than one-third of total world gross domestic product (GDP), but account for more than half of GDP growth.[9]

TABLE 4–1 Some Important Variables in the Societal Environment

Economic	Technological	Political–Legal	Sociocultural
GDP trends	Total government spending for R&D	Antitrust regulations	Lifestyle changes
Interest rates	Total industry spending for R&D	Environmental protection laws	Career expectations
Money supply	Focus of technological efforts	Global warming legislation	Consumer activism
Inflation rates	Patent protection	Immigration laws	Rate of family formation
Unemployment levels	New products	Tax laws	Growth rate of population
Wage/price controls	New developments in technology transfer from lab to marketplace	Special incentives	Age distribution of population
Devaluation/revaluation	Productivity improvements through automation	Foreign trade regulations	Regional shifts in population
Energy alternatives	Internet availability	Attitudes toward foreign companies	Life expectancies
Energy availability and cost	Telecommunication infrastructure	Laws on hiring and promotion	Birthrates
Disposable and discretionary income	Computer hacking activity	Stability of government	Pension plans
Currency markets		Outsourcing regulation	Health care
Global financial system		Foreign "sweat shops"	Level of education
			Living wage
			Unionization

Changes in the *technological* part of the societal environment can also have a great impact on multiple industries. Improvements in computer microprocessors have not only led to the widespread use of personal computers but also to better automobile engine performance in terms of power and fuel economy through the use of microprocessors to monitor fuel injection. Digital technology allows movies and music to be available instantly over the Internet or through cable service, but it also means falling fortunes for video rental shops such as the Movie Gallery and CD stores such as Tower Records. Advances in nanotechnology are enabling companies to manufacture extremely small devices that are very energy efficient. Developing biotechnology, including gene manipulation techniques, is already providing new approaches to dealing with disease and agriculture. Researchers at George Washington University have identified a number of technological breakthroughs that are already having a significant impact on many industries:

- **Portable information devices and electronic networking:** Combining the computing power of the personal computer, the networking of the Internet, the images of the television, and the convenience of the telephone, these appliances will soon be used by a majority of the population of industrialized nations to make phone calls, send e-mail, and transmit documents and other data. Even now, homes, autos, and offices are being connected (via wires and wirelessly) into intelligent networks that interact with one another. This trend is being supported by the development of *cloud computing*, in which a person can tap into computing power elsewhere through a Web connection.[10] The traditional standalone desktop computer may soon join the manual typewriter as a historical curiosity.
- **Alternative energy sources:** The use of wind, geothermal, hydroelectric, solar, biomass, and other alternative energy sources should increase considerably. Over the past two decades, the cost of manufacturing and installing a photovoltaic solar-power system has decreased by 20% with every doubling of installed capacity. The cost of generating electricity from conventional sources, in contrast, has been rising along with the price of petroleum and natural gas.[11]
- **Precision farming:** The computerized management of crops to suit variations in land characteristics will make farming more efficient and sustainable. Farm equipment dealers such as Case and John Deere add this equipment to tractors for an additional $6,000 or so. It enables farmers to reduce costs, increase yields, and decrease environmental impact. The old system of small, low-tech farming is becoming less viable as large corporate farms increase crop yields on limited farmland for a growing population.
- **Virtual personal assistants:** Very smart computer programs that monitor e-mail, faxes, and phone calls will be able to take over routine tasks, such as writing a letter, retrieving a file, making a phone call, or screening requests. Acting like a secretary, a person's virtual assistant could substitute for a person at meetings or in dealing with routine actions.
- **Genetically altered organisms:** A convergence of biotechnology and agriculture is creating a new field of life sciences. Plant seeds can be genetically modified to produce more needed vitamins or to be less attractive to pests and more able to survive. Animals (including people) could be similarly modified for desirable characteristics and to eliminate genetic disabilities and diseases.
- **Smart, mobile robots:** Robot development has been limited by a lack of sensory devices and sophisticated artificial intelligence systems. Improvements in these areas mean that robots will be created to perform more sophisticated factory work, run errands, do household chores, and assist the disabled.[12]

Trends in the *political–legal* part of the societal environment have a significant impact not only on the level of competition within an industry but also on which strategies might be successful.[13] For example, periods of strict enforcement of U.S. antitrust laws directly affect corporate growth

strategy. As large companies find it more difficult to acquire another firm in the same or a related industry, they are typically driven to diversify into unrelated industries.[14] High levels of taxation and constraining labor laws in Western European countries stimulate companies to alter their competitive strategies or find better locations elsewhere. It is because Germany has some of the highest labor and tax costs in Europe that German companies have been forced to compete at the top end of the market with high-quality products or else move their manufacturing to lower-cost countries.[15] Government bureaucracy can create multiple regulations and make it almost impossible for a business firm to operate profitably in some countries. For example, the number of days needed to obtain the government approvals necessary to start a new business vary from only one day in Singapore to 14 in Mexico, 59 in Saudi Arabia, 87 in Indonesia, to 481 in the Congo.[16]

The $66 trillion global economy operates through a set of rules established by the World Trade Organization (WTO). Composed of 153 member nations and 30 observer nations, the WTO is a forum for governments to negotiate trade agreements and settle trade disputes. Originally founded in 1947 as the General Agreement on Tariffs and Trade (GATT), the WTO was created in 1995 to extend the ground rules for international commerce. The system's purpose is to encourage free trade among nations with the least undesirable side effects. Among its principles is trade without discrimination. This is exemplified by its *most-favored nation* clause, which states that a country cannot grant a trading partner lower customs duties without granting them to all other WTO member nations. Another principle is that of lowering trade barriers gradually though negotiation. It implements this principle through a series of rounds of trade negotiations. As a result of these negotiations, industrial countries' tariff rates on industrial goods had fallen steadily to less than 4% by the mid-1990s. The WTO is currently negotiating its ninth round of negotiations, called the Doha Round. The WTO is also in favor of fair competition, predictability of member markets, and the encouragement of economic development and reform. As a result of many negotiations, developed nations have started to allow duty-free and quota-free imports from almost all products from the least-developed countries.[17]

Demographic trends are part of the *sociocultural* aspect of the societal environment. Even though the world's population is growing from 3.71 billion people in 1970 to 6.82 billion in 2010 to 8.72 billion by 2040, not all regions will grow equally. Most of the growth will be in the developing nations. The population of the developed nations will fall from 14% of the total world population in 2000 to only 10% in 2050.[18] Around 75% of the world will live in a city by 2050 compared to little more than half in 2008.[19] Developing nations will continue to have more young than old people, but it will be the reverse in the industrialized nations. For example, the demographic bulge in the U.S. population caused by the baby boom in the 1950s continues to affect market demand in many industries. This group of 77 million people now in their 50s and 60s is the largest age group in all developed countries, especially in Europe. **(See Table 4–2.)** Although the median age in the United States will rise from 35 in 2000 to 40 by 2050, it will increase from 40 to 47 during the same time period in Germany, and it will increase up to 50 in Italy as soon as 2025.[20] By 2050, one in three Italians will be over 65, nearly

TABLE 4–2 Current U.S. Generations

Generation	Born	Age in 2005	Number
WWII/Silent Generation	1932–1945	60–73	32 million
Baby Boomers	1946–1964	41–59	77 million
Generation X	1965–1977	28–40	45 million
Generation Y	1978–1994	11–27	70 million

SOURCE: Developed from data listed in D. Parkinson, *Voices of Experience: Mature Workers in the Future Workforce* (New York: The Conference Board, 2002), p. 19.

double the number in 2005.[21] With its low birthrate, Japan's population is expected to fall from 127.6 million in 2004 to around 100 million by 2050.[22] China's stringent birth control policy is causing the ratio of workers to retirees to fall from 20 to 1 during the early 1980s to 2.5 to one by 2020.[23] Companies with an eye on the future can find many opportunities to offer products and services to the growing number of "woofies" (well-off old folks—defined as people over 50 with money to spend).[24] These people are very likely to purchase recreational vehicles (RVs), take ocean cruises, and enjoy leisure sports, such as boating, fishing, and bowling, in addition to needing financial services and health care. Anticipating the needs of seniors for prescription drugs is one reason the Walgreen Company has been opening a new corner pharmacy every 19 hours![25]

To attract older customers, retailers will need to place seats in their larger stores so aging shoppers can rest. Washrooms need to be more accessible. Signs need to be larger. Restaurants need to raise the level of lighting so people can read their menus. Home appliances need simpler and larger controls. Automobiles need larger door openings and more comfortable seats. Zimmer Holdings, an innovative manufacturer of artificial joints, is looking forward to its market growing rapidly over the next 20 years. According to J. Raymond Elliot, chair and CEO of Zimmer, "It's simple math. Our best years are still in front of us."[26]

Eight current sociocultural trends are transforming North America and the rest of the world:

1. **Increasing environmental awareness:** Recycling and conservation are becoming more than slogans. Busch Gardens, for example, has eliminated the use of disposable styrofoam trays in favor of washing and reusing plastic trays.
2. **Growing health consciousness:** Concerns about personal health fuel the trend toward physical fitness and healthier living. As a result, sales growth is slowing at fast-food "burgers and fries" retailers such as McDonald's. Changing public tastes away from sugar-laden processed foods forced Interstate Bakeries, the maker of Twinkies and Wonder Bread, to declare bankruptcy in 2004. In 2008, the French government was considering increasing sales taxes on extra-fatty, salty, or sugary products.[27] The European Union forbade the importation of genetically altered grain ("Frankenfood") because of possible side effects. The spread of AIDS to more than 40 million people worldwide adds even further impetus to the health movement.
3. **Expanding seniors market:** As their numbers increase, people over age 55 will become an even more important market. Already some companies are segmenting the senior population into Young Matures, Older Matures, and the Elderly—each having a different set of attitudes and interests. Both mature segments, for example, are good markets for the health care and tourism industries; whereas, the elderly are the key market for long-term care facilities. The desire for companionship by people whose children are grown is causing the pet care industry to grow 4.5% annually in the United States. In 2007, for example, 71.1 million households in the U.S. spent $41 billion on their pets—more than the gross domestic product of all but 16 countries in the world.[28]
4. **Impact of Generation Y Boomlet:** Born between 1978 and 1994 to the baby boom and X generations, this cohort is almost as large as the baby boom generation. In 1957, the peak year of the postwar boom, 4.3 million babies were born. In 1990, there were 4.2 million births in Generation Y's peak year. By 2000, they were overcrowding elementary and high schools and entering college in numbers not seen since the baby boomers. Now in its teens and 20s, this cohort is expected to have a strong impact on future products and services.
5. **Declining mass market:** Niche markets are defining the marketers' environment. People want products and services that are adapted more to their personal needs. For example, Estée Lauder's "All Skin" and Maybelline's "Shades of You" lines of cosmetic products are specifically made for African-American women. "Mass customization"—the making

and marketing of products tailored to a person's requirements (Dell for example, and Gateway computers)—is replacing the mass production and marketing of the same product in some markets. Only 10% of the 6,200 magazines sold in the United States in 2004 were aimed at the mass market, down from 30% in the 1970s.[29]

6. **Changing pace and location of life:** Instant communication via e-mail, cell phones, and overnight mail enhances efficiency, but it also puts more pressure on people. Merging the personal computer with the communication and entertainment industries through telephone lines, satellite dishes, and cable television increases consumers' choices and allows workers to leave overcrowded urban areas for small towns and telecommute via personal computers and modems.
7. **Changing household composition:** Single-person households, especially those of single women with children, could soon become the most common household type in the United States. Married-couple households slipped from nearly 80% in the 1950s to 50.7% of all households in 2002.[30] By 2007, for the first time in U.S. history, more than half of women were single.[31] Thirty-eight percent of U.S. children are currently being born out of wedlock.[32] A typical family household is no longer the same as it was once portrayed in *The Brady Bunch* in the 1970s or *The Cosby Show* in the 1980s.
8. **Increasing diversity of workforce and markets:** Between now and 2050, minorities will account for nearly 90% of population growth in the United States. Over time, group percentages of the total United States population are expected to change as follows: Non-Hispanic Whites—from 90% in 1950 to 74% in 1995 to 53% by 2050; Hispanic Whites—from 9% in 1995 to 22% in 2050; Blacks—from 13% in 1995 to 15% in 2050; Asians—from 4% in 1995 to 9% in 2050; American Indians—1%, with slight increase.[33]

   Heavy immigration from the developing to the developed nations is increasing the number of minorities in all developed countries and forcing an acceptance of the value of diversity in races, religions, and life style. For example, 24% of the Swiss population was born elsewhere.[34] Traditional minority groups are increasing their numbers in the workforce and are being identified as desirable target markets. For example, Sears, Roebuck transformed 97 of its stores in October 2004 into "multicultural stores" containing fashions for Hispanic, African-American, and Asian shoppers.[35]

International Societal Considerations. Each country or group of countries in which a company operates presents a unique societal environment with a different set of economic, technological, political–legal, and sociocultural variables for the company to face. International societal environments vary so widely that a corporation's internal environment and strategic management process must be very flexible. Cultural trends in Germany, for example, have resulted in the inclusion of worker representatives in corporate strategic planning. Because Islamic law (*sharia*) forbids interest (*riba*), loans of capital in Islamic countries must be arranged on the basis of profit-sharing instead of interest rates.[36]

Differences in societal environments strongly affect the ways in which a **multinational corporation (MNC)**, a company with significant assets and activities in multiple countries, conducts its marketing, financial, manufacturing, and other functional activities. For example, Europe's lower labor productivity, due to a shorter work week and restrictions on the ability to lay off unproductive workers, forces European-based MNCs to expand operations in countries where labor is cheaper and productivity is higher.[37] Moving manufacturing to a lower-cost location, such as China, was a successful strategy during the 1990s, but a country's labor costs rise as it develops economically. For example, China required all firms in January 2008 to consult employees on material work-related issues, enabling the country to achieve its stated objective of having trade unions in all of China's non-state-owned enterprises. By September 2008, the All-China Federation of Trade Unions had signed with 80% of the largest foreign companies.[38]

To account for the many differences among societal environments from one country to another, consider **Table 4–3**. It includes a list of economic, technological, political–legal, and sociocultural variables for any particular country or region. For example, an important economic variable for any firm investing in a foreign country is currency convertibility. Without convertibility, a company operating in Russia cannot convert its profits from rubles to dollars or euros. In terms of sociocultural variables, many Asian cultures (especially China) are less concerned with the values of human rights than are European and North American cultures. Some Asians actually contend that U.S. companies are trying to impose Western human rights requirements on them in an attempt to make Asian products less competitive by raising their costs.[39]

Before planning its strategy for a particular international location, a company must scan the particular country environment(s) in question for opportunities and threats, and it must compare those with its own organizational strengths and weaknesses. Focusing only on the developed nations may cause a corporation to miss important market opportunities in the developing nations of the world. Although those nations may not have developed to the point that they have significant demand for a broad spectrum of products, they may very likely be on the threshold of rapid growth in the demand for specific products like cell phones. This would be the ideal time for a company to enter this market—before competition is established. The key is to be able to identify the *trigger point* when demand for a particular product or service is ready to boom. See the **Global Issue** boxed highlight for an in-depth explanation of a technique to identify the optimum time to enter a particular market in a developing nation.

Creating a Scanning System. How can anyone monitor and keep track of all the trends and factors in the worldwide societal environment? With the existence of the Internet, it is now possible to scan the entire world. Nevertheless, the vast amount of raw data makes scanning

TABLE 4–3 Some Important Variables in *International* Societal Environments

Economic	Technological	Political–Legal	Sociocultural
Economic development	Regulations on technology transfer	Form of government	Customs, norms, values
Per capita income	Energy availability/cost	Political ideology	Language
Climate	Natural resource availability	Tax laws	Demographics
GDP trends	Transportation network	Stability of government	Life expectancies
Monetary and fiscal policies	Skill level of workforce	Government attitude toward foreign companies	Social institutions
Unemployment levels	Patent-trademark protection	Regulations on foreign ownership of assets	Status symbols
Currency convertibility	Internet availability	Strength of opposition groups	Lifestyle
Wage levels	Telecommunication infrastructure	Trade regulations	Religious beliefs
Nature of competition	Computer hacking technology	Protectionist sentiment	Attitudes toward foreigners
Membership in regional economic associations, e.g., EU, NAFTA, ASEAN	New energy sources	Foreign policies	Literacy level
Membership in World Trade Organization (WTO)		Terrorist activity	Human rights
Outsourcing capability		Legal system	Environmentalism
Global financial system		Global warming laws	"Sweat shops"
		Immigration laws	Pension plans
			Health care
			Slavery

GLOBAL issue

IDENTIFYING POTENTIAL MARKETS IN DEVELOPING NATIONS

Research by the Deloitte & Touche Consulting Group reveals that the demand for a specific product increases exponentially at certain points in a country's development. Identifying this trigger point of demand is thus critical to entering emerging markets at the best time. A *trigger point* is the time when enough people have enough money to buy what a company has to sell but before competition is established. This can be determined by using the concept of *purchasing power parity (PPP),* which measures the cost in dollars of the U.S.–produced equivalent volume of goods that an economy produces.

PPP offers an estimate of the material wealth a nation can purchase, rather than the financial wealth it creates as typically measured by Gross Domestic Product (GDP). As a result, restating a nation's GDP in PPP terms reveals much greater spending power than market exchange rates would suggest. For example, a shoe shine costing $5 to $10 in New York City can be purchased for 50¢ in Mexico City. Consequently the people of Mexico City can enjoy the same standard of living (with respect to shoe shines) as people in New York City with only 5% to 10% of the money. Correcting for PPP restates all Mexican shoe shines at their U.S. purchase value of $5. If one million shoe shines were purchased in Mexico last year, using the PPP model would effectively increase the Mexican GDP by $5 million to $10 million. Using PPP, China becomes the world's second-largest economy after the United States, followed by Japan, India, and Germany.

A trigger point identifies when demand for a particular product is about to rapidly increase in a country. Identifying a trigger point can be a very useful technique for determining when to enter a new market in a developing nation. Trigger points vary for different products. For example, an apparent trigger point for long-distance telephone services is at $7,500 in GDP per capita—a point when demand for telecommunications services increases rapidly. Once national wealth surpasses $15,000 per capita, demand increases at a much slower rate with further increases in wealth. The trigger point for life insurance is around $8,000 in GDP per capita. At this point, the demand for life insurance increases between 200% and 300% above those countries with GDP per capita below the trigger point.

SOURCE: D. Fraser and M. Raynor, "The Power of Parity," *Forecast* (May/June, 1996), pp. 8–12; "A Survey of the World Economy: The Dragon and the Eagle," Special Insert, *Economist* (October 2, 2004), p. 8; "The Big Mac Index: Food for Thought," *Economist* (May 29, 2004), pp. 71–72.

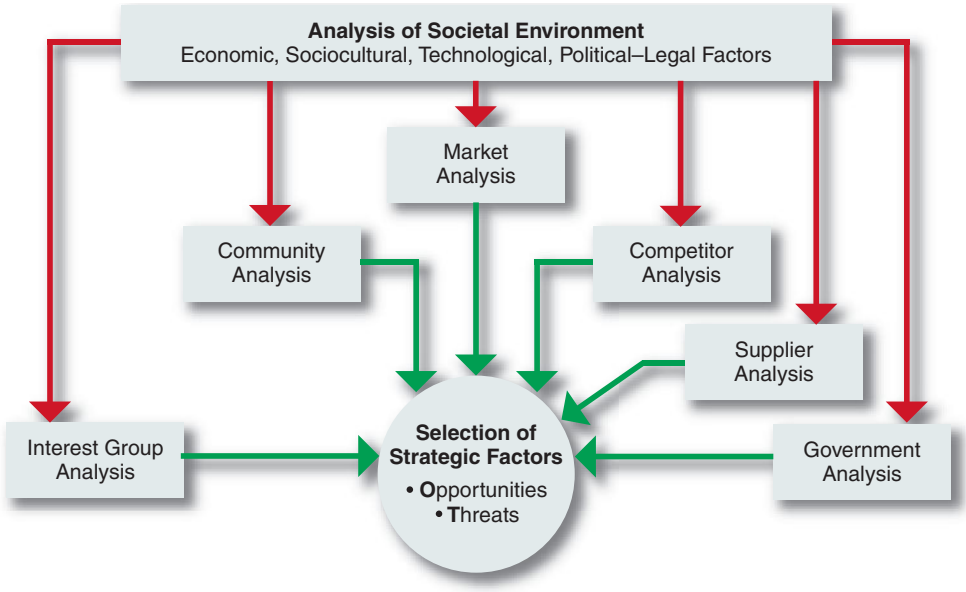
for information similar to drinking from a fire hose. It is a daunting task for even a large corporation with many resources. To deal with this problem, in 2002 IBM created a tool called *WebFountain* to help the company analyze the vast amounts of environmental data available on the Internet. WebFountain is an advanced information discovery system designed to help extract trends, detect patterns, and find relationships within vast amounts of raw data. For example, IBM sought to learn whether there was a trend toward more positive discussions about e-business. Within a week, the company had data that experts within the company used to replace their hunches with valid conclusions. The company uses WebFountain to:

- Locate negative publicity or investor discontent
- Track general trends
- Learn competitive information
- Identify emerging competitive threats
- Unravel consumer attitudes[40]

Scanning the Task Environment

As shown in **Figure 4–1**, a corporation's scanning of the environment includes analyses of all the relevant elements in the task environment. These analyses take the form of individual reports written by various people in different parts of the firm. At Procter & Gamble (P&G), for

FIGURE 4–1
Scanning External Environment



example, people from each of the brand management teams work with key people from the sales and market research departments to research and write a "competitive activity report" each quarter on each of the product categories in which P&G competes. People in purchasing also write similar reports concerning new developments in the industries that supply P&G. These and other reports are then summarized and transmitted up the corporate hierarchy for top management to use in strategic decision making. If a new development is reported regarding a particular product category, top management may then send memos asking people throughout the organization to watch for and report on developments in related product areas. The many reports resulting from these scanning efforts, when boiled down to their essentials, act as a detailed list of external strategic factors.

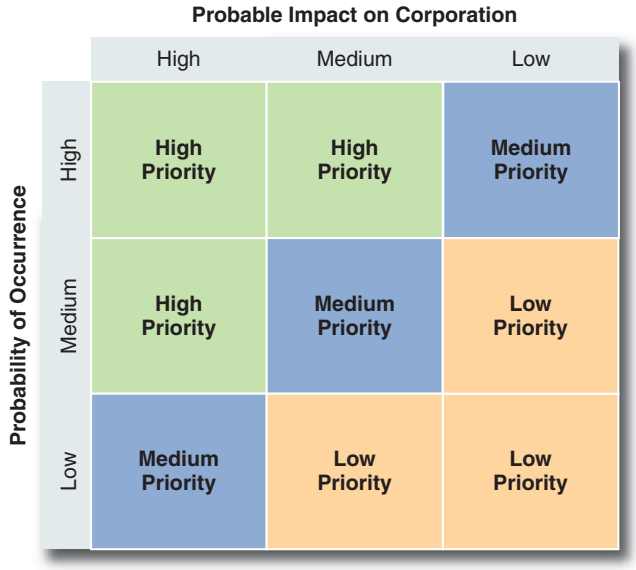
IDENTIFYING EXTERNAL STRATEGIC FACTORS

The origin of competitive advantage lies in the ability to identify and respond to environmental change well in advance of competition.[41] Although this seems obvious, why are some companies better able to adapt than others? One reason is because of differences in the ability of managers to recognize and understand external strategic issues and factors. For example, in a global survey conducted by the Fuld-Gilad-Herring Academy of Competitive Intelligence, two-thirds of 140 corporate strategists admitted that their firms had been surprised by as many as three high-impact events in the past five years. Moreover, as recently as 2003, 97% stated that their companies had no early warning system in place.[42]

No firm can successfully monitor all external factors. Choices must be made regarding which factors are important and which are not. Even though managers agree that strategic importance determines what variables are consistently tracked, they sometimes miss or choose to ignore crucial new developments.[43] Personal values and functional experiences of a corporation's managers as well as the success of current strategies are likely to bias both their perception of what is important to monitor in the external environment and their interpretations of what they perceive.[44]

This willingness to reject unfamiliar as well as negative information is called *strategic myopia*.[45] If a firm needs to change its strategy, it might not be gathering the appropriate external

FIGURE 4–2
Issues Priority Matrix



SOURCE: *Reprinted from* Long-Range Planning, *Vol. 17, No. 3, 1984, Campbell, "Foresight Activities in the U.S.A.: Time for a Re-Assessment?" p. 46. Copyright © 1984 with permission from Elsevier.*

information to change strategies successfully. For example, when Daniel Hesse became CEO of Sprint Nextel in December 2007, he assumed that improving customer service would be one of his biggest challenges. He quickly discovered that none of the current Sprint Nextel executives were even thinking about the topic. "We weren't talking about the customer when I first joined," said Hesse. "Now this is the No. 1 priority of the company."[46]

One way to identify and analyze developments in the external environment is to use the **issues priority matrix** (see **Figure 4–2**) as follows:

1. Identify a number of likely trends emerging in the natural, societal, and task environments. These are strategic environmental issues—those important trends that, if they occur, determine what the industry or the world will look like in the near future.
2. Assess the probability of these trends actually occurring, from low to medium to high.
3. Attempt to ascertain the likely impact (from low to high) of each of these trends on the corporation being examined.

A corporation's *external strategic factors* are the key environmental trends that are judged to have both a medium to high probability of occurrence and a medium to high probability of impact on the corporation. The issues priority matrix can then be used to help managers decide which environmental trends should be merely scanned (low priority) and which should be monitored as strategic factors (high priority). Those environmental trends judged to be a corporation's strategic factors are then categorized as opportunities and threats and are included in strategy formulation.

4.2 Industry Analysis: Analyzing the Task Environment

An **industry** is a group of firms that produces a similar product or service, such as soft drinks or financial services. An examination of the important stakeholder groups, such as suppliers and customers, in a particular corporation's task environment is a part of industry analysis.

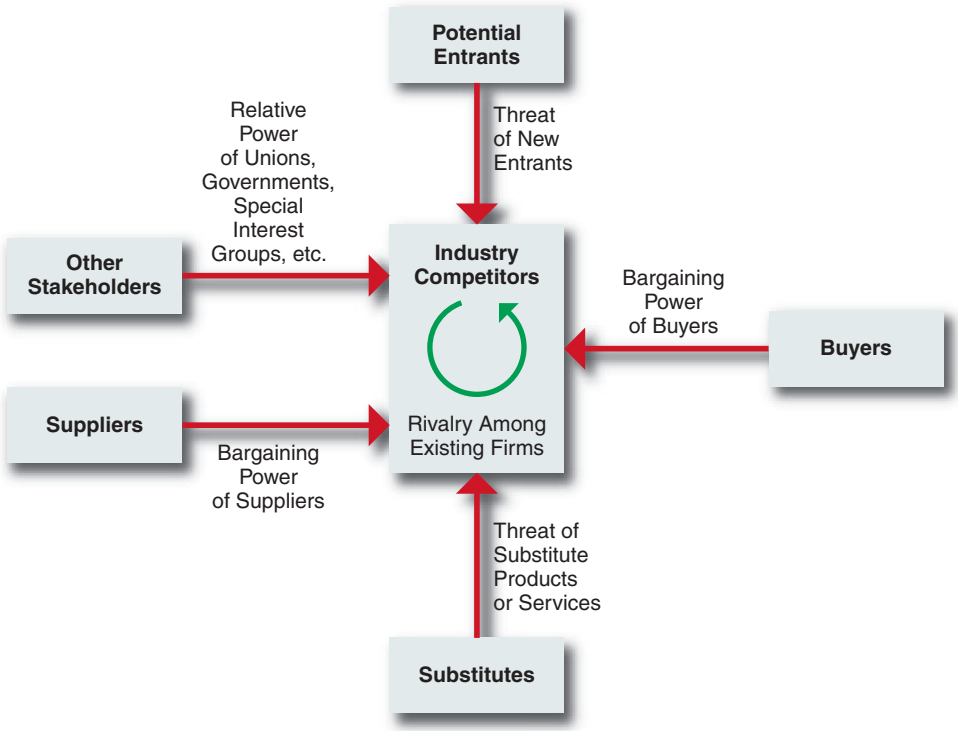
PORTER'S APPROACH TO INDUSTRY ANALYSIS

Michael Porter, an authority on competitive strategy, contends that a corporation is most concerned with the intensity of competition within its industry. The level of this intensity is determined by basic competitive forces, as depicted in **Figure 4–3.** "The collective strength of these forces," he contends, "determines the ultimate profit potential in the industry, where profit potential is measured in terms of long-run return on invested capital."[47] In carefully scanning its industry, a corporation must assess the importance to its success of each of six forces: threat of new entrants, rivalry among existing firms, threat of substitute products or services, bargaining power of buyers, bargaining power of suppliers, and relative power of other stakeholders.[48] The stronger each of these forces, the more limited companies are in their ability to raise prices and earn greater profits. Although Porter mentions only five forces, a sixth—other stakeholders—is added here to reflect the power that governments, local communities, and other groups from the task environment wield over industry activities.

Using the model in **Figure 4–3,** a high force can be regarded as a threat because it is likely to reduce profits. A low force, in contrast, can be viewed as an opportunity because it may allow the company to earn greater profits. In the short run, these forces act as constraints on a company's activities. In the long run, however, it may be possible for a company, through its choice of strategy, to change the strength of one or more of the forces to the company's advantage. For example, Dell's early use of the Internet to market its computers was an effective way to negate the bargaining power of distributors in the PC industry.

A strategist can analyze any industry by rating each competitive force as high, medium, or low in strength. For example, the global athletic shoe industry could be rated as follows:

FIGURE 4–3
Forces Driving Industry Competition



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rivalry is high (Nike, Reebok, New Balance, Converse, and Adidas are strong competitors worldwide), threat of potential entrants is low (the industry has reached maturity/sales growth rate has slowed), threat of substitutes is low (other shoes don't provide support for sports activities), bargaining power of suppliers is medium but rising (suppliers in Asian countries are increasing in size and ability), bargaining power of buyers is medium but increasing (prices are falling as the low-priced shoe market has grown to be half of the U.S. branded athletic shoe market), and threat of other stakeholders is medium to high (government regulations and human rights concerns are growing). Based on current trends in each of these competitive forces, the industry's level of competitive intensity will continue to be high—meaning that sales increases and profit margins should continue to be modest for the industry as a whole.[49]

Threat of New Entrants

New entrants to an industry typically bring to it new capacity, a desire to gain market share, and substantial resources. They are, therefore, threats to an established corporation. The threat of entry depends on the presence of entry barriers and the reaction that can be expected from existing competitors. An **entry barrier** is an obstruction that makes it difficult for a company to enter an industry. For example, no new domestic automobile companies have been successfully established in the United States since the 1930s because of the high capital requirements to build production facilities and to develop a dealer distribution network. Some of the possible barriers to entry are:

- **Economies of scale:** Scale economies in the production and sale of microprocessors, for example, gave Intel a significant cost advantage over any new rival.
- **Product differentiation:** Corporations such as Procter & Gamble and General Mills, which manufacture products such as Tide and Cheerios, create high entry barriers through their high levels of advertising and promotion.
- **Capital requirements:** The need to invest huge financial resources in manufacturing facilities in order to produce large commercial airplanes creates a significant barrier to entry to any competitor for Boeing and Airbus.
- **Switching costs:** Once a software program such as Excel or Word becomes established in an office, office managers are very reluctant to switch to a new program because of the high training costs.
- **Access to distribution channels:** Small entrepreneurs often have difficulty obtaining supermarket shelf space for their goods because large retailers charge for space on their shelves and give priority to the established firms who can pay for the advertising needed to generate high customer demand.
- **Cost disadvantages independent of size:** Once a new product earns sufficient market share to be accepted as the *standard* for that type of product, the maker has a key advantage. Microsoft's development of the first widely adopted operating system (MS-DOS) for the IBM-type personal computer gave it a significant competitive advantage over potential competitors. Its introduction of Windows helped to cement that advantage so that the Microsoft operating system is now on more than 90% of personal computers worldwide.
- **Government policy:** Governments can limit entry into an industry through licensing requirements by restricting access to raw materials, such as oil-drilling sites in protected areas.

Rivalry among Existing Firms

In most industries, corporations are mutually dependent. A competitive move by one firm can be expected to have a noticeable effect on its competitors and thus may cause retaliation. For

example, the entry by mail order companies such as Dell and Gateway into a PC industry previously dominated by IBM, Apple, and Compaq increased the level of competitive activity to such an extent that any price reduction or new product introduction was quickly followed by similar moves from other PC makers. The same is true of prices in the United States airline industry. According to Porter, intense rivalry is related to the presence of several factors, including:

- **Number of competitors:** When competitors are few and roughly equal in size, such as in the auto and major home appliance industries, they watch each other carefully to make sure that they match any move by another firm with an equal countermove.
- **Rate of industry growth:** Any slowing in passenger traffic tends to set off price wars in the airline industry because the only path to growth is to take sales away from a competitor.
- **Product or service characteristics:** A product can be very unique, with many qualities differentiating it from others of its kind or it may be a *commodity*, a product whose characteristics are the same, regardless of who sells it. For example, most people choose a gas station based on location and pricing because they view gasoline as a commodity.
- **Amount of fixed costs:** Because airlines must fly their planes on a schedule, regardless of the number of paying passengers for any one flight, they offer cheap standby fares whenever a plane has empty seats.
- **Capacity:** If the only way a manufacturer can increase capacity is in a large increment by building a new plant (as in the paper industry), it will run that new plant at full capacity to keep its unit costs as low as possible—thus producing so much that the selling price falls throughout the industry.
- **Height of exit barriers: Exit barriers** keep a company from leaving an industry. The brewing industry, for example, has a low percentage of companies that voluntarily leave the industry because breweries are specialized assets with few uses except for making beer.
- **Diversity of rivals:** Rivals that have very different ideas of how to compete are likely to cross paths often and unknowingly challenge each other's position. This happens often in the retail clothing industry when a number of retailers open outlets in the same location—thus taking sales away from each other. This is also likely to happen in some countries or regions when multinational corporations compete in an increasingly global economy.

Threat of Substitute Products or Services

A **substitute product** is a product that appears to be different but can satisfy the same need as another product. For example, e-mail is a substitute for the fax, Nutrasweet is a substitute for sugar, the Internet is a substitute for video stores, and bottled water is a substitute for a cola. According to Porter, "Substitutes limit the potential returns of an industry by placing a ceiling on the prices firms in the industry can profitably charge."[50] To the extent that switching costs are low, substitutes may have a strong effect on an industry. Tea can be considered a substitute for coffee. If the price of coffee goes up high enough, coffee drinkers will slowly begin switching to tea. The price of tea thus puts a price ceiling on the price of coffee. Sometimes a difficult task, the identification of possible substitute products or services means searching for products or services that can perform the same function, even though they have a different appearance and may not appear to be easily substitutable.

Bargaining Power of Buyers

Buyers affect an industry through their ability to force down prices, bargain for higher quality or more services, and play competitors against each other. A buyer or a group of buyers is powerful if some of the following factors hold true:

- A buyer purchases a large proportion of the seller's product or service (for example, oil filters purchased by a major auto maker).
- A buyer has the potential to integrate backward by producing the product itself (for example, a newspaper chain could make its own paper).
- Alternative suppliers are plentiful because the product is standard or undifferentiated (for example, motorists can choose among many gas stations).
- Changing suppliers costs very little (for example, office supplies are easy to find).
- The purchased product represents a high percentage of a buyer's costs, thus providing an incentive to shop around for a lower price (for example, gasoline purchased for resale by convenience stores makes up half their total costs).
- A buyer earns low profits and is thus very sensitive to costs and service differences (for example, grocery stores have very small margins).
- The purchased product is unimportant to the final quality or price of a buyer's products or services and thus can be easily substituted without affecting the final product adversely (for example, electric wire bought for use in lamps).

Bargaining Power of Suppliers

Suppliers can affect an industry through their ability to raise prices or reduce the quality of purchased goods and services. A supplier or supplier group is powerful if some of the following factors apply:

- The supplier industry is dominated by a few companies, but it sells to many (for example, the petroleum industry).
- Its product or service is unique and/or it has built up switching costs (for example, word processing software).
- Substitutes are not readily available (for example, electricity).
- Suppliers are able to integrate forward and compete directly with their present customers (for example, a microprocessor producer such as Intel can make PCs).
- A purchasing industry buys only a small portion of the supplier group's goods and services and is thus unimportant to the supplier (for example, sales of lawn mower tires are less important to the tire industry than are sales of auto tires).

Relative Power of Other Stakeholders

A sixth force should be added to Porter's list to include a variety of stakeholder groups from the task environment. Some of these groups are governments (if not explicitly included elsewhere), local communities, creditors (if not included with suppliers), trade associations, special-interest groups, unions (if not included with suppliers), shareholders, and complementors. According to Andy Grove, Chairman and past CEO of Intel, a **complementor** is a company (e.g., Microsoft) or an industry whose product works well with a firm's (e.g., Intel's) product and without which the product would lose much of its value.[51] An example of complementary industries is the tire and automobile industries. Key international stakeholders who determine many of the international trade regulations and standards are the World Trade Organization, the European Union, NAFTA, ASEAN, and Mercosur.

The importance of these stakeholders varies by industry. For example, environmental groups in Maine, Michigan, Oregon, and Iowa successfully fought to pass bills outlawing disposable bottles and cans, and thus deposits for most drink containers are now required. This effectively raised costs across the board, with the most impact on the marginal producers who

could not internally absorb all these costs. The traditionally strong power of national unions in the United States' auto and railroad industries has effectively raised costs throughout these industries but is of little importance in computer software.

INDUSTRY EVOLUTION

Over time, most industries evolve through a series of stages from growth through maturity to eventual decline. The strength of each of the six forces mentioned earlier varies according to the stage of industry evolution. The industry life cycle is useful for explaining and predicting trends among the six forces that drive industry competition. For example, when an industry is new, people often buy the product, regardless of price, because it fulfills a unique need. This usually occurs in a **fragmented industry**—where no firm has large market share, and each firm serves only a small piece of the total market in competition with others (for example, cleaning services).[52] As new competitors enter the industry, prices drop as a result of competition. Companies use the experience curve (discussed in **Chapter 5**) and economies of scale to reduce costs faster than the competition. Companies integrate to reduce costs even further by acquiring their suppliers and distributors. Competitors try to differentiate their products from one another's in order to avoid the fierce price competition common to a maturing industry.

By the time an industry enters maturity, products tend to become more like commodities. This is now a **consolidated industry**—dominated by a few large firms, each of which struggles to differentiate its products from those of the competition. As buyers become more sophisticated over time, purchasing decisions are based on better information. Price becomes a dominant concern, given a minimum level of quality and features, and profit margins decline. The automobile, petroleum, and major home appliance industries are examples of mature, consolidated industries each controlled by a few large competitors. In the case of the United States major home appliance industry, the industry changed from being a fragmented industry (pure competition) composed of hundreds of appliance manufacturers in the industry's early years to a consolidated industry (mature oligopoly) composed of three companies controlling over 90% of United States appliance sales. A similar consolidation is occurring now in European major home appliances.

As an industry moves through maturity toward possible decline, its products' growth rate of sales slows and may even begin to decrease. To the extent that exit barriers are low, firms begin converting their facilities to alternate uses or sell them to other firms. The industry tends to consolidate around fewer but larger competitors. The tobacco industry is an example of an industry currently in decline.

CATEGORIZING INTERNATIONAL INDUSTRIES

According to Porter, world industries vary on a continuum from multidomestic to global (see **Figure 4–4**).[53] **Multidomestic industries** are specific to each country or group of countries. This type of international industry is a collection of essentially domestic industries, such as

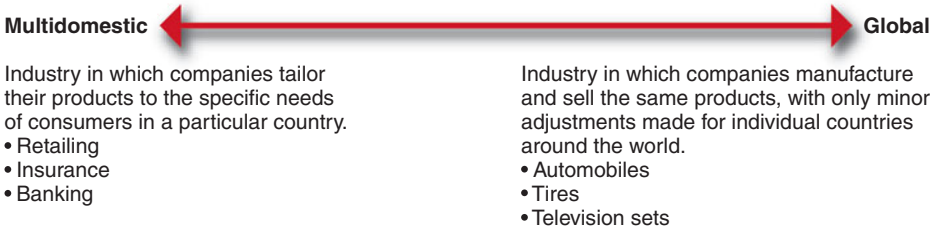


FIGURE 4–4
Continuum of International Industries

retailing and insurance. The activities in a subsidiary of a multinational corporation (MNC) in this type of industry are essentially independent of the activities of the MNC's subsidiaries in other countries. Within each country, it has a manufacturing facility to produce goods for sale within that country. The MNC is thus able to tailor its products or services to the very specific needs of consumers in a particular country or group of countries having similar societal environments.

Global industries, in contrast, operate worldwide, with MNCs making only small adjustments for country-specific circumstances. In a global industry an MNC's activities in one country are significantly affected by its activities in other countries. MNCs in global industries produce products or services in various locations throughout the world and sell them, making only minor adjustments for specific country requirements. Examples of global industries are commercial aircraft, television sets, semiconductors, copiers, automobiles, watches, and tires. The largest industrial corporations in the world in terms of sales revenue are, for the most part, MNCs operating in global industries.

The factors that tend to determine whether an industry will be primarily multidomestic or primarily global are:

1. *Pressure for coordination* within the MNCs operating in that industry
2. *Pressure for local responsiveness* on the part of individual country markets

To the extent that the pressure for coordination is strong and the pressure for local responsiveness is weak for MNCs within a particular industry, that industry will tend to become global. In contrast, when the pressure for local responsiveness is strong and the pressure for coordination is weak for multinational corporations in an industry, that industry will tend to be multidomestic. Between these two extremes lie a number of industries with varying characteristics of both multidomestic and global industries. These are **regional industries**, in which MNCs primarily coordinate their activities within regions, such as the Americas or Asia.[54] The major home appliance industry is a current example of a regional industry becoming a global industry. Japanese appliance makers, for example, are major competitors in Asia, but only minor players in Europe or America. The dynamic tension between the pressure for coordination and the pressure for local responsiveness is contained in the phrase, "*Think globally but act locally*."

INTERNATIONAL RISK ASSESSMENT

Some firms develop elaborate information networks and computerized systems to evaluate and rank investment risks. Small companies may hire outside consultants, such as Boston's Arthur D. Little Inc., to provide political-risk assessments. Among the many systems that exist to assess political and economic risks are the Business Environment Risk Index, the Economist Intelligence Unit, and Frost and Sullivan's World Political Risk Forecasts. The Economist Intelligence Unit, for example, provides a constant flow of analysis and forecasts on more than 200 countries and eight key industries. Regardless of the source of data, a firm must develop its own method of assessing risk. It must decide on its most important risk factors and then assign weights to each.

STRATEGIC GROUPS

A **strategic group** is a set of business units or firms that "pursue similar strategies with similar resources."[55] Categorizing firms in any one industry into a set of strategic groups is very useful as a way of better understanding the competitive environment.[56] Research shows that some strategic groups in the same industry are more profitable than others.[57] Because a corporation's structure and culture tend to reflect the kinds of strategies it follows, companies or

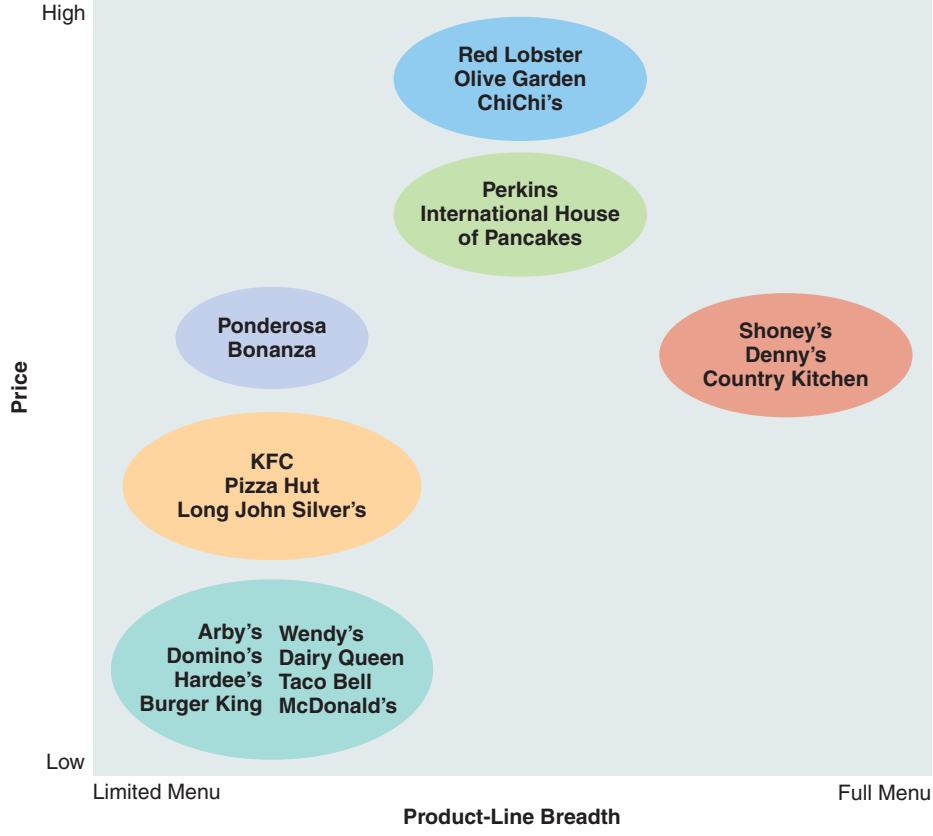
business units belonging to a particular strategic group within the same industry tend to be strong rivals and tend to be more similar to each other than to competitors in other strategic groups within the same industry.[58]

For example, although McDonald's and Olive Garden are a part of the same industry, the restaurant industry, they have different missions, objectives, and strategies, and thus they belong to different strategic groups. They generally have very little in common and pay little attention to each other when planning competitive actions. Burger King and Hardee's, however, have a great deal in common with McDonald's in terms of their similar strategy of producing a high volume of low-priced meals targeted for sale to the average family. Consequently, they are strong rivals and are organized to operate similarly.

Strategic groups in a particular industry can be mapped by plotting the market positions of industry competitors on a two-dimensional graph, using two strategic variables as the vertical and horizontal axes (See **Figure 4–5**):

1. Select two broad characteristics, such as price and menu, that differentiate the companies in an industry from one another.
2. Plot the firms, using these two characteristics as the dimensions.
3. Draw a circle around those companies that are closest to one another as one strategic group, varying the size of the circle in proportion to the group's share of total industry sales. (You could also name each strategic group in the restaurant industry with an identifying title, such as quick fast food or buffet-style service.)

FIGURE 4–5
Mapping Strategic Groups in the U.S. Restaurant Chain Industry



Other dimensions, such as quality, service, location, or degree of vertical integration, could also be used in additional graphs of the restaurant industry to gain a better understanding of how the various firms in the industry compete. Keep in mind, however, that the two dimensions should not be highly correlated; otherwise, the circles on the map will simply lie along the diagonal, providing very little new information other than the obvious.

STRATEGIC TYPES

In analyzing the level of competitive intensity within a particular industry or strategic group, it is useful to characterize the various competitors for predictive purposes. A **strategic type** is a category of firms based on a common strategic orientation and a combination of structure, culture, and processes consistent with that strategy. According to Miles and Snow, competing firms within a single industry can be categorized into one of four basic types on the basis of their general strategic orientation.[59] This distinction helps explain why companies facing similar situations behave differently and why they continue to do so over long periods of time.[60] These general types have the following characteristics:

- **Defenders** are companies with a limited product line that *focus on improving the efficiency of their existing operations*. This cost orientation makes them unlikely to innovate in new areas. With its emphasis on efficiency, Lincoln Electric is an example of a defender.
- **Prospectors** are companies with fairly broad product lines that *focus on product innovation and market opportunities*. This sales orientation makes them somewhat inefficient. They tend to emphasize creativity over efficiency. Rubbermaid's emphasis on new product development makes it an example of a prospector.
- **Analyzers** are corporations that *operate in at least two different product-market areas*, one stable and one variable. In the stable areas, efficiency is emphasized. In the variable areas, innovation is emphasized. Multidivisional firms, such as IBM and Procter & Gamble, which operate in multiple industries, tend to be analyzers.
- **Reactors** are corporations that *lack a consistent strategy-structure-culture relationship*. Their (often ineffective) responses to environmental pressures tend to be piecemeal strategic changes. Most major U.S. airlines have recently tended to be reactors—given the way they have been forced to respond to new entrants such as Southwest and JetBlue.

Dividing the competition into these four categories enables the strategic manager not only to monitor the effectiveness of certain strategic orientations, but also to develop scenarios of future industry developments (discussed later in this chapter).

HYPERCOMPETITION

Most industries today are facing an ever-increasing level of environmental uncertainty. They are becoming more complex and more dynamic. Industries that used to be multidomestic are becoming global. New flexible, aggressive, innovative competitors are moving into established markets to rapidly erode the advantages of large previously dominant firms. Distribution channels vary from country to country and are being altered daily through the use of sophisticated information systems. Closer relationships with suppliers are being forged to reduce costs, increase quality, and gain access to new technology. Companies learn to quickly imitate the successful strategies of market leaders, and it becomes harder to sustain any competitive advantage for very long. Consequently, the level of competitive intensity is increasing in most industries.

Richard D'Aveni contends that as this type of environmental turbulence reaches more industries, competition becomes **hypercompetition**. According to D'Aveni:

> *In hypercompetition the frequency, boldness, and aggressiveness of dynamic movement by the players accelerates to create a condition of constant disequilibrium and change. Market stability is threatened by short product life cycles, short product design cycles, new technologies, frequent entry by unexpected outsiders, repositioning by incumbents, and tactical redefinitions of market boundaries as diverse industries merge. In other words, environments escalate toward higher and higher levels of uncertainty, dynamism, heterogeneity of the players and hostility.*[61]

In hypercompetitive industries such as computers, competitive advantage comes from an up-to-date knowledge of environmental trends and competitive activity coupled with a willingness to risk a current advantage for a possible new advantage. Companies must be willing to *cannibalize* their own products (that is, replace popular products before competitors do so) in order to sustain their competitive advantage. See **Strategy Highlight 4.1** to learn how Microsoft is operating in the hypercompetitive industry of computer software. (Hypercompetition is discussed in more detail in **Chapter 6**.)

USING KEY SUCCESS FACTORS TO CREATE AN INDUSTRY MATRIX

Within any industry there are usually certain variables—key success factors—that a company's management must understand in order to be successful. **Key success factors** are variables that can significantly affect the overall competitive positions of companies within any particular industry. They typically vary from industry to industry and are crucial to determining a company's ability to succeed within that industry. They are usually determined by the

STRATEGY highlight 4.1

MICROSOFT IN A HYPERCOMPETITIVE INDUSTRY

Microsoft is a hypercompetitive firm operating in a hypercompetitive industry. It has used its dominance in operating systems (DOS and Windows) to move into a very strong position in application programs such as word processing and spreadsheets (Word and Excel). Even though Microsoft held 90% of the market for personal computer operating systems in 1992, it still invested millions in developing the next generation—Windows 95 and Windows NT. These were soon followed by Windows Me, XP, and Vista. Instead of trying to protect its advantage in the profitable DOS operating system, Microsoft actively sought to replace DOS with various versions of Windows. Before hypercompetition, most experts argued against *cannibalization* of a company's own product line because it destroys a very profitable product instead of harvesting it like a "cash cow." According to this line of thought, a company would be better off defending its older products. New products would be introduced only if it could be proven that they would not take sales away from current products. Microsoft was one of the first companies to disprove this argument against cannibalization.

Bill Gates, Microsoft's co-founder, chair, and CEO, realized that if his company didn't replace its own DOS product line with a better product, someone else would (such as Linux or IBM's OS/2 Warp). He knew that success in the software industry depends not so much on company size as on moving aggressively to the next competitive advantage before a competitor does. "This is a hypercompetitive market," explained Gates. "Scale is not all positive in this business. Cleverness is the position in this business." By 2008, Microsoft still controlled over 90% of operating systems software and had achieved a dominant position in applications software as well.

SOURCE: Richard A. D'Aveni, "Hypercompetition: Managing the Dynamics of Strategic Maneuvering." Copyright © 1994 by Richard A. D'Aveni. All rights reserved.

TABLE 4–4 Industry Matrix

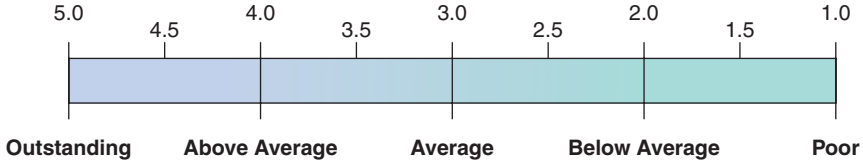
Key Success Factors	Weight	Company A Rating	Company A Weighted Score	Company B Rating	Company B Weighted Score
1	2	3	4	5	6
Total	1.00				

SOURCE: T. L. Wheelen and J. D. Hunger, *Industry Matrix.* Copyright © 1997, 2001, and 2005 by Wheelen & Hunger Associates. Reprinted with permission.

economic and technological characteristics of the industry and by the competitive weapons on which the firms in the industry have built their strategies.[62] For example, in the major home appliance industry, a firm must achieve low costs, typically by building large manufacturing facilities dedicated to making multiple versions of one type of appliance, such as washing machines. Because 60% of major home appliances in the United States are sold through "power retailers" such as Sears and Best Buy, a firm must have a strong presence in the mass merchandiser distribution channel. It must offer a full line of appliances and provide a just-in-time delivery system to keep store inventory and ordering costs to a minimum. Because the consumer expects reliability and durability in an appliance, a firm must have excellent process R&D. Any appliance manufacturer that is unable to deal successfully with these key success factors will not survive long in the U.S. market.

An **industry matrix** summarizes the key success factors within a particular industry. As shown in **Table 4–4**, the matrix gives a weight for each factor based on how important that factor is for success within the industry. The matrix also specifies how well various competitors in the industry are responding to each factor. To generate an industry matrix using two industry competitors (called A and B), complete the following steps for the industry being analyzed:

1. In **Column 1** (***Key Success Factors***), list the 8 to 10 factors that appear to determine success in the industry.
2. In **Column 2** (***Weight***), assign a weight to each factor, from **1.0** (*Most Important*) to **0.0** (*Not Important*) based on that factor's probable impact on the overall industry's current and future success. **(All weights must sum to 1.0 regardless of the number of strategic factors.)**
3. In **Column 3** (***Company A Rating***), examine a particular company within the industry—for example, Company A. Assign a rating to each factor from **5** (*Outstanding*) to **1** (*Poor*) based on Company A's current response to that particular factor. Each rating is a judgment regarding how well that company is specifically dealing with each key success factor.



4. In **Column 4** (***Company A Weighted Score***), multiply the weight in **Column 2** for each factor by its rating in **Column 3** to obtain that factor's weighted score for Company A.

5. In **Column 5** (***Company B Rating***), examine a second company within the industry - in this case, Company B. Assign a rating to each key success factor from **5.0** (Outstanding) to **1.0** (Poor), based on Company B's current response to each particular factor.
6. In **Column 6** (***Company B Weighted Score***), multiply the weight in **Column 2** for each factor times its rating in **Column 5** to obtain that factor's weighted score for Company B.
7. Finally, add the weighted scores for all the factors in **Columns 4** and **6** to determine the total weighted scores for companies A and B. **The total weighted score indicates how well each company is responding to current and expected key success factors in the industry's environment.** Check to ensure that the total weighted score truly reflects the company's current performance in terms of profitability and market share. (An average company should have a total weighted score of 3.)

The industry matrix can be expanded to include all the major competitors within an industry through the addition of two additional columns for each additional competitor.

4.3 Competitive Intelligence

Much external environmental scanning is done on an informal and individual basis. Information is obtained from a variety of sources—suppliers, customers, industry publications, employees, industry experts, industry conferences, and the Internet.[63] For example, scientists and engineers working in a firm's R&D lab can learn about new products and competitors' ideas at professional meetings; someone from the purchasing department, speaking with supplier-representatives' personnel, may also uncover valuable bits of information about a competitor. A study of product innovation found that 77% of all product innovations in scientific instruments and 67% in semiconductors and printed circuit boards were initiated by the customer in the form of inquiries and complaints.[64] In these industries, the sales force and service departments must be especially vigilant.

A recent survey of global executives by McKinsey & Company found that the single factor contributing most to the increasing competitive intensity in their industries was the improved capabilities of competitors.[65] Yet, without competitive intelligence, companies run the risk of flying blind in the marketplace. In a 2008 survey of global executives, the majority revealed that their companies typically learned about a competitor's price change or significant innovation too late to respond before it was introduced into the market.[66] According to work by Ryall, firms can have competitive advantages simply because their rivals have erroneous beliefs about them.[67] This is why competitive intelligence has become an important part of environmental scanning in most companies.

Competitive intelligence is a formal program of gathering information on a company's competitors. Often called *business intelligence*, it is one of the fastest growing fields within strategic management. Research indicates that there is a strong association between corporate performance and competitive intelligence activities.[68] According to a survey of competitive intelligence professionals, the primary reasons for practicing competitive intelligence are to build industry awareness (90.6%), support the strategic planning process (79.2%), develop new products (73.6%), and create new marketing strategies and tactics.[69] As early as the 1990s, 78% of large U.S. corporations conducted competitive intelligence activities.[70] In about a third of the firms, the competitive/business intelligence function is housed in its own unit, with the remainder being housed within marketing, strategic planning, information services, business development (merger & acquisitions), product development, or other units.[71] According to a

2007 survey of 141 large American corporations, spending on competitive intelligence activities was rising from $1 billion in 2007 to $10 billion by 2012.[72] At General Mills, for example, all employees have been trained to recognize and tap sources of competitive information. Janitors no longer simply place orders with suppliers of cleaning materials; they also ask about relevant practices at competing firms!

SOURCES OF COMPETITIVE INTELLIGENCE

Most corporations use outside organizations to provide them with environmental data. Firms such as A. C. Nielsen Co. provide subscribers with bimonthly data on brand share, retail prices, percentages of stores stocking an item, and percentages of stock-out stores. Strategists can use this data to spot regional and national trends as well as to assess market share. Information on market conditions, government regulations, industry competitors, and new products can be bought from "information brokers" such as Market Research.com (Findex), LexisNexis (company and country analyses), and Finsbury Data Services. Company and industry profiles are generally available from the Hoover's Web site, at www.hoovers.com. Many business corporations have established their own in-house libraries and computerized information systems to deal with the growing mass of available information.

The Internet has changed the way strategists engage in environmental scanning. It provides the quickest means to obtain data on almost any subject. Although the scope and quality of Internet information is increasing geometrically, it is also littered with "noise," misinformation, and utter nonsense. For example, a number of corporate Web sites are sending unwanted guests to specially constructed bogus Web sites.[73] Unlike the library, the Internet lacks the tight bibliographic control standards that exist in the print world. There is no ISBN or Dewey Decimal System to identify, search, and retrieve a document. Many Web documents lack the name of the author and the date of publication. A Web page providing useful information may be accessible on the Web one day and gone the next. Unhappy ex-employees, far-out environmentalists, and prank-prone hackers create "blog" Web sites to attack and discredit an otherwise reputable corporation. Rumors with no basis in fact are spread via chat rooms and personal Web sites. This creates a serious problem for researchers. How can one evaluate the information found on the Internet? For a way to evaluate intelligence information, see **Strategy Highlight 4.2.**

Some companies choose to use industrial espionage or other intelligence-gathering techniques to get their information straight from their competitors. According to a survey by the American Society for Industrial Security, PricewaterhouseCoopers, and the United States Chamber of Commerce, Fortune 1000 companies lost an estimated $59 billion in one year alone due to the theft of trade secrets.[74] By using current or former competitors' employees and private contractors, some firms attempt to steal trade secrets, technology, business plans, and pricing strategies. For example, Avon Products hired private investigators to retrieve from a public dumpster documents (some of them shredded) that Mary Kay Corporation had thrown away. Oracle Corporation also hired detectives to obtain the trash of a think tank that had defended the pricing practices of its rival Microsoft. Studies reveal that 32% of the trash typically found next to copy machines contains confidential company data, in addition to personal data (29%) and gossip (39%).[75] Even P&G, which defends itself like a fortress from information leaks, is vulnerable. A competitor was able to learn the precise launch date of a concentrated laundry detergent in Europe when one of its people visited the factory where machinery was being made. Simply asking a few questions about what a certain machine did, whom it was for, and when it would be delivered was all that was necessary.

Some of the firms providing investigatory services are Kroll Inc. with 4,000 employees in 25 countries, Fairfax, Security Outsourcing Solutions, Trident Group, and Diligence Inc.[76] Trident, for example, specializes in helping American companies enter the Russian market and

STRATEGY highlight 4.2

EVALUATING COMPETITIVE INTELLIGENCE

A basic rule in intelligence gathering is that before a piece of information can be used in any report or briefing, it must first be evaluated in two ways. *First*, the source of the information should be judged in terms of its truthfulness and reliability. How trustworthy is the source? How well can a researcher rely upon it for truthful and correct information? One approach is to rank the reliability of the source on a scale from A (extremely reliable), B (reliable), C (unknown reliability), D (probably unreliable), to E (very questionable reliability). The reliability of a source can be judged on the basis of the author's credentials, the organization sponsoring the information, and past performance, among other factors. *Second*, the information or data should be judged in terms of its likelihood of being correct. The correctness of the data may be ranked on a scale from 1 (correct), 2 (probably correct), 3 (unknown), 4 (doubtful), to 5 (extremely doubtful). The correctness of a piece of data or information can be judged on the basis of its agreement with other bits of separately-obtained information or with a general trend supported by previous data. For every piece of information found on the Internet, for example, list not only the URL of the Web page, but also the evaluation of the information from A1 (good stuff) to E5 (bad doodoo). Information found through library research in sources such as Moody's Industrials, Standard & Poor's, or Value Line can generally be evaluated as having a reliability of A. The correctness of the data can still range anywhere from 1 to 5, but in most instances is likely to be either 1 or 2, but probably no worse than 3 or 4. Web sites are quite different.

Web sites, such as those sponsored by the U.S. Securities and Exchange Commission (www.sec.gov), the Economist (www.economist.com), or Hoovers Online (www.hoovers.com) are extremely reliable. Company-sponsored Web sites are generally reliable, but are not the place to go for trade secrets, strategic plans, or proprietary information. For one thing, many firms think of their Web sites primarily in terms of marketing and provide little data aside from product descriptions and distributors. Other companies provide their latest financial statements and links to other useful Web sites. Nevertheless, some companies in very competitive industries may install software on their Web site to ascertain a visitor's web address. Visitors from a competitor's domain name are thus screened before they are allowed to access certain Web sites. They may not be allowed beyond the product information page or they may be sent to a bogus Web site containing misinformation. Cisco Systems, for example, uses its Web site to send visitors from other high-tech firms to a special Web page asking if they would like to apply for a job at Cisco!

is a U.S.-based corporate intelligence firm founded and managed by former veterans of Russian intelligence services, like the KGB.[77]

To combat the increasing theft of company secrets, the United States government passed the Economic Espionage Act in 1996. The law makes it illegal (with fines up to $5 million and 10 years in jail) to steal any material that a business has taken "reasonable efforts" to keep secret and that derives its value from not being known.[78] The Society of Competitive Intelligence Professionals (www.scip.org) urges strategists to stay within the law and to act ethically when searching for information. The society states that illegal activities are foolish because the vast majority of worthwhile competitive intelligence is available publicly via annual reports, Web sites, and libraries. Unfortunately, a number of firms hire "kites," consultants with questionable reputations, who do what is necessary to get information when the selected methods do not meet SPIC ethical standards or are illegal. This allows the company that initiated the action to deny that it did anything wrong.[79]

MONITORING COMPETITORS FOR STRATEGIC PLANNING

The primary activity of a competitive intelligence unit is to monitor **competitors**—organizations that offer same, similar, or substitutable products or services in the business area in which a particular company operates. To understand a competitor, it is important to answer the following 10 questions:

1. Why do your competitors exist? Do they exist to make profits or just to support another unit?
2. Where do they add customer value—higher quality, lower price, excellent credit terms, or better service?
3. Which of your customers are the competitors most interested in? Are they cherry-picking your best customers, picking the ones you don't want, or going after all of them?
4. What is their cost base and liquidity? How much cash do they have? How do they get their supplies?
5. Are they less exposed with their suppliers than your firm? Are their suppliers better than yours?
6. What do they intend to do in the future? Do they have a strategic plan to target your market segments? How committed are they to growth? Are there any succession issues?
7. How will their activity affect your strategies? Should you adjust your plans and operations?
8. How much better than your competitor do you need to be in order to win customers? Do either of you have a competitive advantage in the marketplace?
9. Will new competitors or new ways of doing things appear over the next few years? Who is a potential new entrant?
10. If you were a customer, would you choose your product over those offered by your competitors? What irritates your current customers? What competitors solve these particular customer complaints?[80]

To answer these and other questions, competitive intelligence professionals utilize a number of analytical techniques. In addition to the previously discussed SWOT analysis, Michael Porter's industry forces analysis, and strategic group analysis, some of these techniques are Porter's four-corner exercise, Treacy and Wiersema's value disciplines, Gilad's blind spot analysis, and war gaming.[81] See **Appendix 4.A** for more information about these competitive analysis techniques.

Done right, competitive intelligence is a key input to strategic planning. Avnet Inc., one of the world's largest distributors of electronic components, uses competitive intelligence in its growth by acquisition strategy. According to John Hovis, Avnet's senior vice president of corporate planning and investor relations:

> *Our competitive intelligence team has a significant responsibility in tracking all of the varied competitors, not just our direct competitors, but all the peripheral competitors that have a potential to impact our ability to create value. . . . One of the things we are about is finding new acquisition candidates, and our competitive intelligence unit is very much involved with our acquisition team, in helping to profile potential acquisition candidates.*[82]

4.4 Forecasting

Environmental scanning provides reasonably hard data on the present situation and current trends, but intuition and luck are needed to accurately predict whether these trends will continue. The resulting forecasts are, however, usually based on a set of assumptions that may or may not be valid.

DANGER OF ASSUMPTIONS

Faulty underlying assumptions are the most frequent cause of forecasting errors. Nevertheless, many managers who formulate and implement strategic plans rarely consider that their success is based on a series of basic assumptions. Many strategic plans are simply based on

projections of the current situation. For example, few people in 2007 expected the price of oil (light, sweet crude, also called West Texas intermediate) to rise above $80 per barrel and were extremely surprised to see the price approach $150 by July 2008, especially since the price had been around $20 per barrel in 2002. U.S. auto companies, in particular, had continued to design and manufacture large cars, pick-up trucks, and SUVs under the assumption of gasoline being available for around $2.00 a gallon. Market demand for these types of cars collapsed when the price of gasoline passed $3.00 to reach $4.00 a gallon in July 2008. In another example, many banks made a number of questionable mortgages based on the assumption that housing prices would continue to rise as they had in the past. When housing prices fell in 2007, these "sub-prime" mortgages were almost worthless—causing a number of banks to sell out or fail in 2008. Assumptions like these can be dangerous to your health!

USEFUL FORECASTING TECHNIQUES

Various techniques are used to forecast future situations. They do not tell the future; they merely state what can be, not what will be. As such, they can be used to form a set of reasonable assumptions about the future. Each technique has its proponents and its critics. A study of nearly 500 of the world's largest corporations revealed trend extrapolation to be the most widely practiced form of forecasting—over 70% use this technique either occasionally or frequently.[83] Simply stated, *extrapolation* is the extension of present trends into the future. It rests on the assumption that the world is reasonably consistent and changes slowly in the short run. Time-series methods are approaches of this type; they attempt to carry a series of historical events forward into the future. The basic problem with extrapolation is that a historical trend is based on a series of patterns or relationships among so many different variables that a change in any one can drastically alter the future direction of the trend. As a rule of thumb, the further back into the past you can find relevant data supporting the trend, the more confidence you can have in the prediction.

Brainstorming, expert opinion, and statistical modeling are also very popular forecasting techniques. *Brainstorming* is a non-quantitative approach that requires simply the presence of people with some knowledge of the situation to be predicted. The basic ground rule is to propose ideas without first mentally screening them. No criticism is allowed. "Wild" ideas are encouraged. Ideas should build on previous ideas until a consensus is reached.[84] This is a good technique to use with operating managers who have more faith in "gut feel" than in more quantitative number-crunching techniques. *Expert opinion* is a nonquantitative technique in which experts in a particular area attempt to forecast likely developments. This type of forecast is based on the ability of a knowledgeable person(s) to construct probable future developments based on the interaction of key variables. One application, developed by the RAND Corporation, is the *Delphi technique,* in which separated experts independently assess the likelihoods of specified events. These assessments are combined and sent back to each expert for fine-tuning until agreement is reached. These assessments are most useful if they are shaped into several possible scenarios that allow decision makers to more fully understand their implication.[85] *Statistical modeling* is a quantitative technique that attempts to discover causal or at least explanatory factors that link two or more time series together. Examples of statistical modeling are regression analysis and other econometric methods. Although very useful in the grasping of historic trends, statistical modeling, such as trend extrapolation, is based on historical data. As the patterns of relationships change, the accuracy of the forecast deteriorates.

Prediction markets is a recent forecasting technique enabled by easy access to the Internet. As emphasized by James Surowiecki in *The Wisdom of Crowds*, the conclusions of large groups can often be better than those of experts because such groups can aggregate a large amount of dispersed wisdom.[86] Prediction markets are small-scale electronic markets, frequently open to any employee, that tie payoffs to measurable future events, such as sales data

for a computer workstation, the number of bugs in an application, or a product usage patterns. These markets yield prices on prediction contracts—prices that can be interpreted as market-aggregated forecasts.[87] Companies including Microsoft, Google, and Eli Lilly have asked their employees to participate in prediction markets by betting on whether products will sell, when new offices will open, and whether profits will be high in the next quarter. Early predictions have been exceedingly accurate.[88] Intrade.com offers a free Web site in which people can buy or sell various predictions in a manner similar to buying or selling common stock. On May 26, 2008, for example, Intrade.com listed the buying price for democratic presidential candidate Barack Obama as $91.50 compared to $8.00 for Hillary Clinton, and $37.70 for John McCain. Thus far, prediction markets have not been documented for long-term forecasting, so its value in strategic planning has not yet been established. Other forecasting techniques, such as *cross-impact analysis (CIA)* and *trend-impact analysis (TIA*), have not established themselves successfully as regularly employed tools.[89]

Scenario writing is the most widely used forecasting technique after trend extrapolation. Originated by Royal Dutch Shell, *scenarios* are focused descriptions of different likely futures presented in a narrative fashion. A scenario thus may be merely a written description of some future state, in terms of key variables and issues, or it may be generated in combination with other forecasting techniques. Often called scenario planning, this technique has been successfully used by 3M, Levi-Strauss, General Electric, United Distillers, Electrolux, British Airways, and Pacific Gas and Electricity, among others.[90] According to Mike Eskew, Chairman and CEO of United Parcel Service, UPS uses scenario writing to envision what its customers might need five to ten years in the future.[91] The four Arctic scenarios that began this chapter are an example of scenario writing that should be an input to a transportation company's strategic planning.

An **industry scenario** is a forecasted description of a particular industry's likely future. Such a scenario is developed by analyzing the probable impact of future societal forces on key groups in a particular industry. The process may operate as follows:[92]

1. Examine possible shifts in the natural environment and in societal variables globally.
2. Identify uncertainties in each of the six forces of the task environment (that is, potential entrants, competitors, likely substitutes, buyers, suppliers, and other key stakeholders).
3. Make a range of plausible assumptions about future trends.
4. Combine assumptions about individual trends into internally consistent scenarios.
5. Analyze the industry situation that would prevail under each scenario.
6. Determine the sources of competitive advantage under each scenario.
7. Predict competitors' behavior under each scenario.
8. Select the scenarios that are either most likely to occur or most likely to have a strong impact on the future of the company. Use these scenarios as assumptions in strategy formulation.

4.5 The Strategic Audit: A Checklist for Environmental Scanning

One way of scanning the environment to identify opportunities and threats is by using the Strategic Audit found in **Appendix 1.A** at the end of Chapter 1. The audit provides a checklist of questions by area of concern. For example, Part III of the audit examines the natural, societal, and task environments. It looks at the societal environment in terms of economic, technological, political-legal, and sociocultural forces. It also considers the task environment

(industry) in terms of threat of new entrants, bargaining power of buyers and suppliers, threat of substitute products, rivalry among existing firms, and the relative power of other stakeholders.

4.6 Synthesis of External Factors—EFAS

After strategic managers have scanned the societal and task environments and identified a number of likely external factors for their particular corporation, they may want to refine their analysis of these factors by using a form such as that given in **Table 4–5**. Using an **EFAS (External Factors Analysis Summary) Table** is one way to organize the external factors into the generally accepted categories of opportunities and threats as well as to analyze how well a particular company's management (rating) is responding to these specific factors in light of the perceived importance (weight) of these factors to the company. To generate an EFAS Table for the company being analyzed, complete the following steps:

1. In **Column 1 (*External Factors*)**, list the eight to ten most important opportunities and threats facing the company.

TABLE 4–5 External Factor Analysis Summary (EFAS Table): Maytag as Example

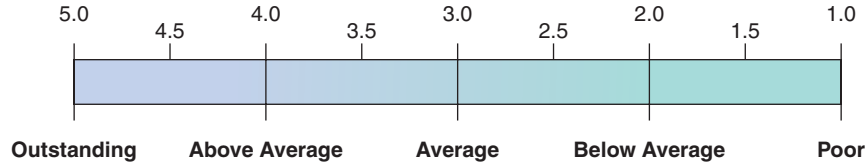
External Factors	Weight	Rating	Weighted Score	Comments
1	2	3	4	5
Opportunities				
■ Economic integration of European Community	.20	4.1	.82	Acquisition of Hoover
■ Demographics favor quality appliances	.10	5.0	.50	Maytag quality
■ Economic development of Asia	.05	1.0	.05	Low Maytag presence
■ Opening of Eastern Europe	.05	2.0	.10	Will take time
■ Trend to "Super Stores"	.10	1.8	.18	Maytag weak in this channel
Threats				
■ Increasing government regulations	.10	4.3	.43	Well positioned
■ Strong U.S. competition	.10	4.0	.40	Well positioned
■ Whirlpool and Electrolux strong globally	.15	3.0	.45	Hoover weak globally
■ New product advances	.05	1.2	.06	Questionable
■ Japanese appliance companies	.10	1.6	.16	Only Asian presence in Australia
Total Scores	1.00		3.15	

NOTES:

1. List opportunities and threats (8–10) in Column 1.
2. Weight each factor from 1.0 (Most Important) to 0.0 (Not Important) in Column 2 based on that factor's probable impact on the company's strategic position. **The total weights must sum to 1.00**.
3. Rate each factor from 5.0 (Outstanding) to 1.0 (Poor) in Column 3 based on the company's response to that factor.
4. Multiply each factor's weight times its rating to obtain each factor's weighted score in Column 4.
5. Use Column 5 (comments) for rationale used for each factor.
6. Add the individual weighted scores to obtain the total weighted score for the company in Column 4. This tells how well the company is responding to the factors in its external environment.

SOURCE: T.L. Wheelen, J.D. Hunger, "External Factors Analysis Summary (EFAS)". Copyright © 1987, 1988, 1989, 1990, and 2005 by T. L Wheelen. Copyright © 1991, 2003, and 2005 by Wheelen & Hunger Associates. Reprinted by permission.

2. In **Column 2 (*Weight*)**, assign a weight to each factor from **1.0** (*Most Important*) to **0.0** (*Not Important*) based on that factor's probable impact on a particular company's current strategic position. The higher the weight, the more important is this factor to the current and future success of the company. **(All weights must sum to 1.0 regardless of the number of factors.)**
3. In **Column 3 (*Rating*)**, assign a rating to each factor from **5.0** (*Outstanding*) to **1.0** (*Poor*) based on that particular company's specific response to that particular factor. Each rating is a judgment regarding how well the company is currently dealing with each specific external factor.



4. In **Column 4 (*Weighted Score*)**, multiply the weight in **Column 2** for each factor times its rating in **Column 3** to obtain that factor's weighted score.
5. In **Column 5 (*Comments*)**, note why a particular factor was selected and how its weight and rating were estimated.
6. Finally, add the weighted scores for all the external factors in **Column 4** to determine the total weighted score for that particular company. The **total weighted** score indicates how well a particular company is responding to current and expected factors in its external environment. The score can be used to compare that firm to other firms in the industry. Check to ensure that the total weighted score truly reflects the company's current performance in terms of profitability and market share. **The total weighted score for an average firm in an industry is always 3.0.**

As an example of this procedure, **Table 4–5** includes a number of external factors for Maytag Corporation with corresponding weights, ratings, and weighted scores provided. This table is appropriate for 1995, long before Maytag was acquired by Whirlpool. Note that Maytag's total weight was 3.15, meaning that the corporation was slightly above average in the major home appliance industry at that time.

End of Chapter SUMMARY

Wayne Gretzky was one of the most famous people ever to play professional ice hockey. He wasn't very fast. His shot was fairly weak. He was usually last in his team in strength training. He tended to operate in the back of his opponent's goal, anticipating where his team members would be long before they got there and fed them passes so unsuspected that he would often surprise his own team members. In an interview with *Time* magazine, Gretzky stated that the key to winning is skating not to where the puck is but to where it is going to be. "People talk about skating, puck handling and shooting, but the whole sport is angles and caroms, forgetting the straight direction the puck is going, calculating where it will be diverted, factoring in all the interruptions," explained Gretzky.[93]

Environmental scanning involves monitoring, collecting, and evaluating information in order to understand the current trends in the natural, societal, and task environments. The

information is then used to forecast whether these trends will continue or whether others will take their place. How will developments in the natural environment affect the world? What kind of developments can we expect in the societal environment to affect our industry? What will an industry look like in 10 to 20 years? Who will be the key competitors? Who is likely to fall by the wayside? We use this information to make certain assumptions about the future—assumptions that are then used in strategic planning. In many ways, success in the business world is like ice hockey: The key to winning is not to assume that your industry will continue as it is now but to assume that the industry will change and to make sure that your company will be in position to take advantage of those changes.

ECO-BITS

- The International Panel on Climate Change reports that carbon dioxide emissions are rising faster than its worst-case scenario and that without new government action greenhouse gases will rise 25% to 90% over 2000 levels by 2030.
- China surpassed the United States in carbon emissions in 2006 by producing 6.6 billion tons of carbon dioxide, 24% of the world's annual production of CO_2.
- The total number of people affected by natural disasters has tripled over the past decade to two billion people.
- By 2025, 1.8 billion people could be living in water-scarce areas with the likely result being mass migrations out of these areas.[94]

DISCUSSION QUESTIONS

1. Discuss how a development in a corporation's natural and societal environments can affect the corporation through its task environment.
2. According to Porter, what determines the level of competitive intensity in an industry?
3. According to Porter's discussion of industry analysis, is Pepsi Cola a substitute for Coca-Cola?
4. How can a decision maker identify strategic factors in a corporation's external international environment?
5. Compare and contrast trend extrapolation with the writing of scenarios as forecasting techniques.

STRATEGIC PRACTICE EXERCISE

How far should people in a business firm go in gathering competitive intelligence? Where do you draw the line?

Evaluate each of the following approaches that a person could use to gather information about competitors. For each approach, mark your feeling about its appropriateness:

1 (DEFINITELY NOT APPROPRIATE), 2 (PROBABLY NOT APPROPRIATE), 3 (UNDECIDED), 4 (PROBABLY APPROPRIATE), OR 5 (DEFINITELY APPROPRIATE).

The business firm should try to get useful information about competitors by:

_____ Carefully studying trade journals
_____ Wiretapping the telephones of competitors
_____ Posing as a potential customer to competitors
_____ Getting loyal customers to put out a phony "request for proposal" soliciting competitors' bids
_____ Buying competitors' products and taking them apart
_____ Hiring management consultants who have worked for competitors
_____ Rewarding competitors' employees for useful "tips"
_____ Questioning competitors' customers and/or suppliers
_____ Buying and analyzing competitors' garbage
_____ Advertising and interviewing for nonexistent jobs

_____ Taking public tours of competitors' facilities

_____ Releasing false information about the company in order to confuse competitors

_____ Questioning competitors' technical people at trade shows and conferences

_____ Hiring key people away from competitors

_____ Analyzing competitors' labor union contracts

_____ Having employees date persons who work for competitors

_____ Studying aerial photographs of competitors' facilities

SOURCE: Developed from W. A. Jones, Jr., and N. B. Bryan, Jr., "Business Ethics and Business Intelligence: An Empirical Study of Information-Gathering Alternatives," *International Journal of Management* (June 1995), pp. 204–208. For actual examples of some of these activities, see J. Kerstetter, P. Burrows, J. Greene, G. Smith, and M. Conlin, "The Dark Side of the Valley," *Business Week* (July 17, 2000), pp. 42–43.

After marking each of the preceding approaches, compare your responses to those of other people in your class. For each approach, the people marking 4 or 5 should say why they thought this particular act would be appropriate. Those who marked 1 or 2 should then state why they thought this act would be inappropriate.

Go to the Web site of the Society for Competitive Intelligence Professionals (www.scip.org). What does SCIP say about these approaches?

KEY TERMS

competitive intelligence (p. 120)
competitors (p. 122)
complementor (p. 113)
consolidated industry (p. 114)
EFAS Table (p. 126)
entry barrier (p. 111)
environmental scanning (p. 98)
environmental uncertainty (p. 98)
exit barrier (p. 112)
fragmented industry (p. 114)
global industry (p. 115)
hypercompetition (p. 118)
industry (p. 109)
industry analysis (p. 99)
industry matrix (p. 119)
industry scenario (p. 125)
issues priority matrix (p. 109)
key success factor (p. 118)
multidomestic industry (p. 114)
multinational corporation (MNC) (p. 105)
natural environment (p. 99)
new entrant (p. 111)
regional industries (p. 115)
societal environment (p. 99)
STEEP analysis (p. 101)
strategic group (p. 115)
strategic type (p. 117)
substitute product (p. 112)
task environment (p. 99)

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APPENDIX 4.A

Competitive Analysis Techniques

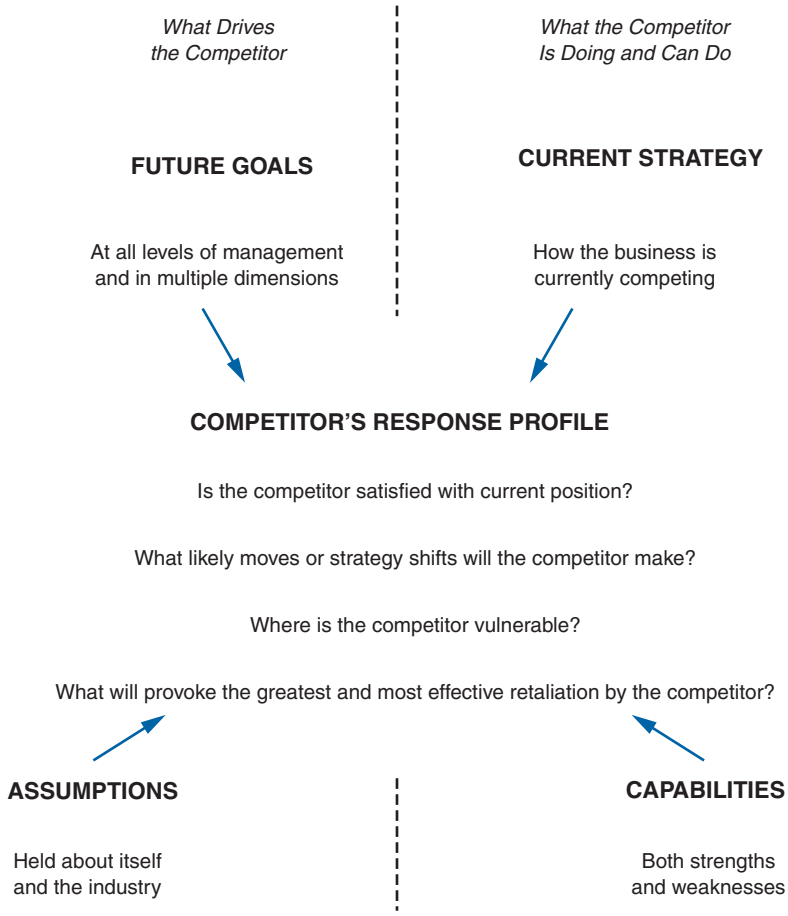
Analytical techniques commonly used in competitive intelligence are *SWOT analysis, Porter's industry forces, ratio analysis*, and *strategic group analysis* (also called *competitive cluster analysis*). In addition to these are Porter's *four-corner exercise*, Treacy and Wiersema's *value disciplines*, and Gilad's *blind spot analysis*. These can be used in a *war game simulation* in which people role-play different competitors and their possible future strategies.

Porter's four-corner exercise involves analyzing a specific competitor's future goals, assumptions, current strategies, and capabilities in order to compile a competitor's response profile. See **Figure 4–6.** Having knowledge of a competitor's goals allows predictions about how likely the competitor is to change strategy and respond to changing conditions. Identifying a competitor's assumptions about itself and the industry can reveal blind spots about how management perceives its environment. Considering a competitor's current strategy and how long it has been in place may indicate whether the company is likely to continue in its current direction. If a strategy is not stated explicitly, one should consider its actions and policies in order to note its implicit strategy. The last step is to objectively evaluate a competitor's capabilities in terms of strengths and weaknesses. The competitor's goals, assumptions, and current strategy influence the likelihood, timing, nature, and intensity of a competitor's reactions. Its strengths and weaknesses determine its ability to initiate or react to strategic moves and to deal with environmental changes.[95]

Treacy and Wiersema's value disciplines involves the evaluation of a competitor in terms of three dimensions: product leadership, operational excellence, and customer intimacy. (See **Figure 4–7**.) After analyzing 80 market-leading companies, Treacy and Wiersema noted that each of these firms developed a compelling and unmatched value proposition on one dimension but was able to maintain acceptable standards on the other two dimensions. *Operationally excellent* companies deliver a combination of quality, price, and ease of purchase that no other can match in their market. An example is Dell Computer, a master of operational excellence. A *product leader* consistently strives to provide its market with leading-edge products or new applications of existing products or services. Johnson & Johnson is an example of a product leader that finds new ideas, develops them quickly, and then looks for ways to improve them. A company that delivers value through *customer intimacy* bonds with its customers and develops high customer loyalty. IBM is an example of a company that pursues excellence in customer intimacy. IBM's current strategy is to provide a total information technology service to its customers so that customers can totally rely on IBM to take care of any Information Technology (IT) problems.[96] According to Wayne Rosenkrans, past president of SCIP, it is possible to mark a spot on each of the three value dimensions shown in **Figure 4–7** for each competitor being analyzed. Then one can draw lines connecting each of the marks, resulting in a triangle that reveals that competitor's overall value proposition.[97]

Gilad's blind spot analysis is based on the premise that the assumptions held by decision makers regarding their own company and their industry may act as perceptual biases or blind spots. As a result, (1) the firm may not be aware of strategically important developments, (2) the firm may inaccurately perceive strategically important developments, or (3) even if the firm is aware of important developments, it may learn too slowly to allow for a timely response. It is important to gather sufficient information about a competitor and its executives to be able to list top management's assumptions about buyers' preferences, the nature of the supply chain, the industry's key success factors, barriers to entry, and the threat appeal of substitutes to customers. One should analyze the industry objectively without regard to these assumptions. Any gap between an objective industry analysis and a competitor's top management assumptions is a potential blind spot. One should include these blind spots when considering how this competitor might respond to environmental change.[98]

FIGURE 4–6
Four-Corner Exercise: Porter's Components of Competitor Analysis



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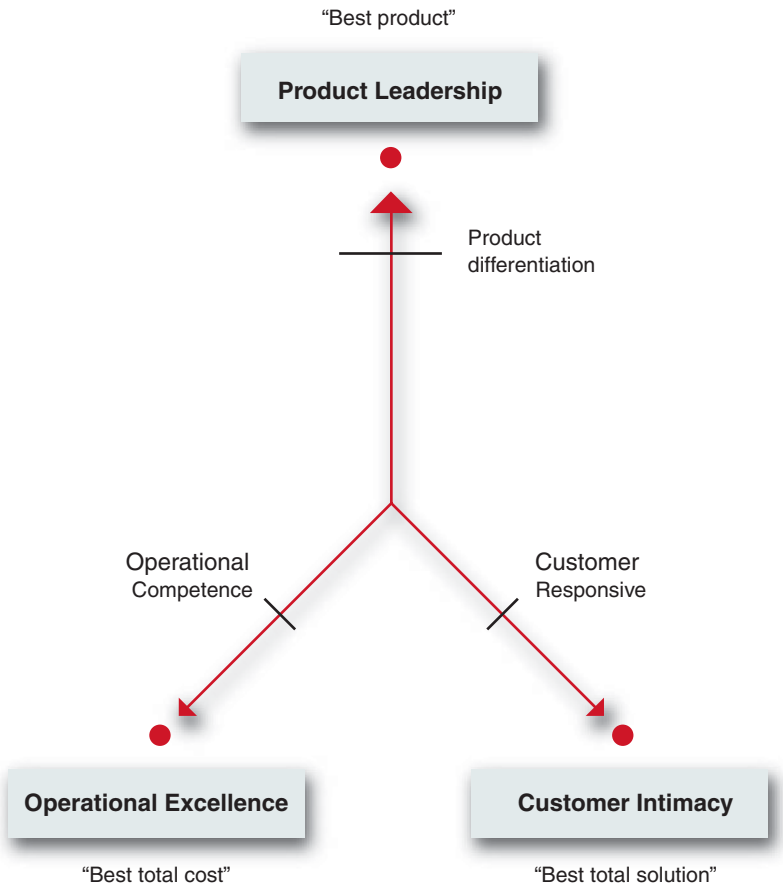
Rosenkrans suggests that an analyst should first use Porter's industry forces technique to develop the four-corner analysis. Then the analyst should use the four-corner analysis to generate a strategic group (cluster) analysis. Finally, the analyst should include the three value dimensions to develop a blind spot analysis.

These techniques can be used to conduct a war game simulating the various competitors in the industry. Gather people from various functional areas in your own corporation and put them into teams identified as industry competitors. Each company team should perform a complete analysis of the competitor it is role-playing. Each company team first creates starting strategies for its company and presents it to the entire group. Each company team then creates counter-strategies and presents them to the entire group. After all the presentations are complete, the full group creates new strategic considerations to be included as items to monitor in future environmental scanning.[99] Some of the companies that have used war gaming successfully are Kimberly Clark, Baxter Healthcare, Lockheed Martin, Hewlett-Packard, and Dow Corning. If a corporation does not have the expertise needed to run a war game, it can utilize management consultants, like KappaWest, who prepare and facilitate a complete war game simulation.

Some competitive intelligence analysts take the war game approach one step further by creating an "invented" company that could appear in the future but does not exist today. A team brainstorms what type of strategy the invented competitor might employ. The strategy is often based on a new breakthrough product that is radically different from current offerings. Its goals, strategies, and competitive

FIGURE 4–7 Value Discipline Triad



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posture should be different from any currently being used in the industry. According to Liam Fahey, an authority on competitive intelligence, "the invented competitor is proving to be a spur to bold and innovative thinking."[100] War games are especially useful when (externally) the market is shifting, competitive rules are changing, new competitors are entering the industry, a significant competitor is changing its strategy, a firm's competitive position is weakening, the "uncontrollables" are getting stronger, and/or when (internally) the company is "flying blind," its current strategy is stale or confused, managers are over-confident or arrogant, and/or the firm suffers from a "silo" mentality.[101]

CHAPTER 5

internal scanning: Organizational Analysis

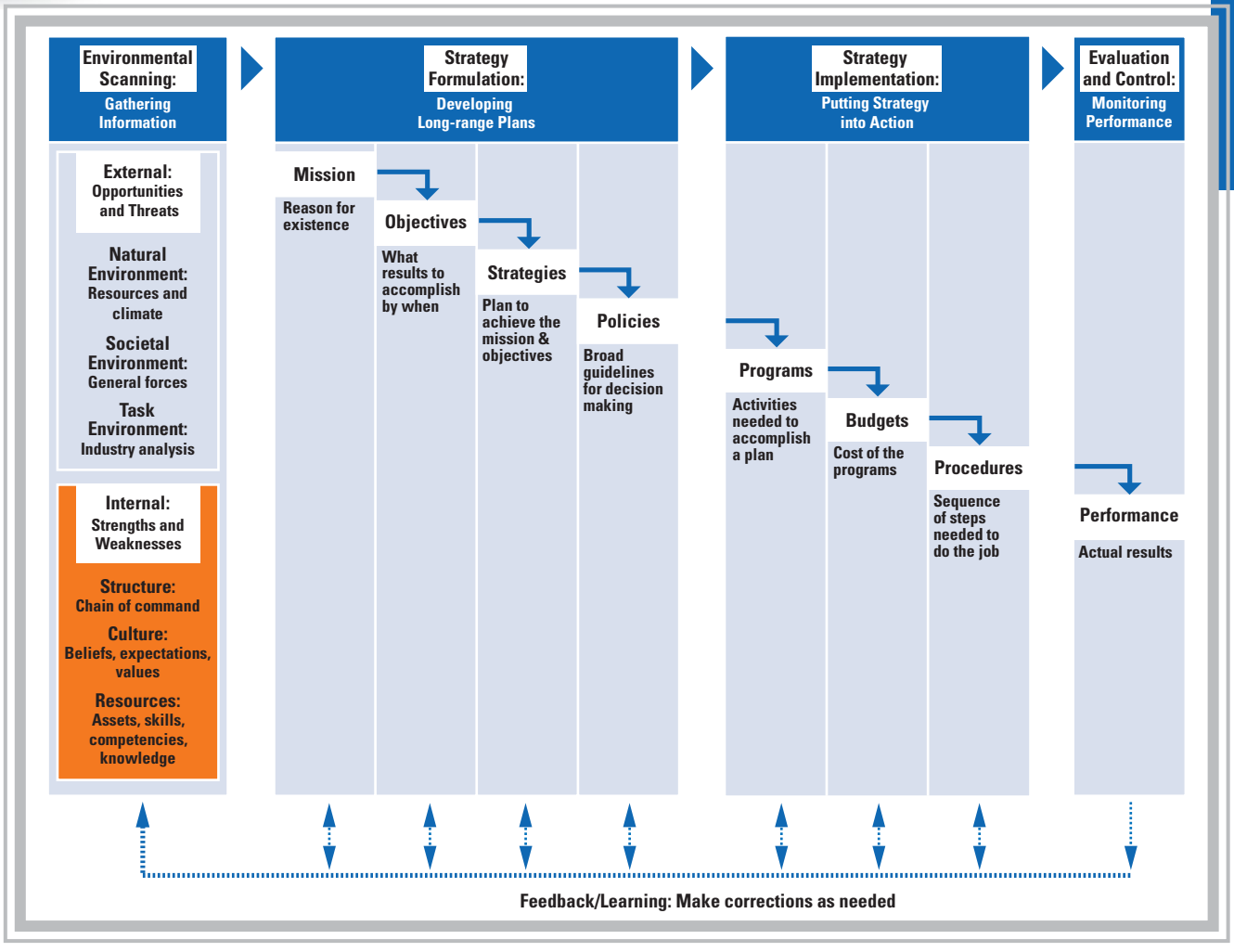
On January 10, 2008, a new automobile from Tata Motors was introduced to the world at the Indian Auto Show in New Delhi. Called the *People's Car*, the new auto was planned to sell for $2,500 in India. Even though many manufacturers were hoping to introduce cheap small cars into India and other developing nations, Tata Motors seemed to have significant advantages that other companies lacked. India's low labor costs meant that Tata could engineer a new model for 20% of the $350 million it would cost in developed nations. A factory worker in Mumbai earned just $1.20 per hour, less than auto workers earned in China. The car was kept very simple. The company would save about $900 per car by skipping equipment that the U.S., Europe, and Japan required for emissions control. The People's Car did not have features like antilock brakes, air bags, or support beams to protect passengers in case of a crash. The dashboard contained just a speedometer, fuel gauge, and oil light. It lacked a radio, reclining seats, or power steering. It came with a small 650 cc engine that generated only 70 horsepower, but obtained 50 to 60 miles per gallon. The car's suspension system used old technology that was cheap, but resulted in a rougher ride than in more expensive cars. More importantly, Tata Motors would save money by using an innovative distribution strategy. Instead of selling completed cars to dealers, Tata planned to supply kits that would then be assembled by the dealers. By eliminating large, centralized assembly plants, Tata could cut the car's retail price by 20%.

Although Tata Motors intended to initially sell the people's car in India and then offer it in other developing markets, management felt that they could build a car that would meet U.S. or European specifications for around $6,000—still a low price for an automobile. Given that Tata Motors was able to acquire Jaguar and Land Rover from Ford later in the year, other auto companies had to admit that Tata was on its way to becoming a major competitor in the industry.[1]

Learning Objectives

After reading this chapter, you should be able to:

- Apply the resource view of the firm to determine core and distinctive competencies
- Use the VRIO framework and the value chain to assess an organization's competitive advantage and how it can be sustained
- Understand a company's business model and how it could be imitated
- Assess a company's corporate culture and how it might affect a proposed strategy
- Scan functional resources to determine their fit with a firm's strategy
- Construct an IFAS Table that summarizes internal factors



5.1 A Resource-Based Approach to Organizational Analysis

Scanning and analyzing the external environment for opportunities and threats is not enough to provide an organization a competitive advantage. Analysts must also look within the corporation itself to identify *internal strategic factors*—critical *strengths and weaknesses* that are likely to determine whether a firm will be able to take advantage of opportunities while avoiding threats. This internal scanning, often referred to as **organizational analysis**, is concerned with identifying and developing an organization's resources and competencies.

CORE AND DISTINCTIVE COMPETENCIES

Resources are an organization's assets and are thus the basic building blocks of the organization. They include *tangible assets*, such as its plant, equipment, finances, and location, *human assets*, in terms of the number of employees, their skills, and motivation, and *intangible assets*, such as its technology (patents and copyrights), culture, and reputation.[2] **Capabilities** refer to a corporation's ability to exploit its resources. They consist of business processes and routines that manage the interaction among resources to turn inputs into outputs. For example, a company's marketing capability can be based on the interaction among its marketing specialists, distribution channels, and sales people. A capability is functionally based and is resident in a particular function. Thus, there are marketing capabilities, manufacturing capabilities, and human resource management capabilities. When these capabilities are constantly being changed and reconfigured to make them more adaptive to an uncertain environment, they are called *dynamic capabilities*.[3] A **competency** is a cross-functional integration and coordination of capabilities. For example, a competency in new product development in one division of a corporation may be the consequence of integrating management of information systems (MIS) capabilities, marketing capabilities, R&D capabilities, and production capabilities within the division. A **core competency** is a collection of competencies that crosses divisional boundaries, is widespread within the corporation, and is something that the corporation can do exceedingly well. Thus, new product development is a core competency if it goes beyond one division.[4] For example, a core competency of Avon Products is its expertise in door-to-door selling. FedEx has a core competency in its application of information technology to all its operations. A company must continually reinvest in a core competency or risk its becoming a *core rigidity* or *deficiency,* that is, a strength that over time matures and may become a weakness.[5] Although it is typically not an asset in the accounting sense, a core competency is a very valuable resource—it does not "wear out" with use. In general, the more core competencies are used, the more refined they get, and the more valuable they become. When core competencies are superior to those of the competition, they are called **distinctive competencies**. For example, General Electric is well known for its distinctive competency in management development. Its executives are sought out by other companies hiring top managers.[6]

Barney, in his **VRIO framework** of analysis, proposes four questions to evaluate a firm's competencies:

1. **Value:** Does it provide customer value and competitive advantage?
2. **Rareness:** Do no other competitors possess it?
3. **Imitability:** Is it costly for others to imitate?
4. **Organization:** Is the firm organized to exploit the resource?

If the answer to each of these questions is *yes* for a particular competency, it is considered to be a strength and thus a distinctive competence.[7] This should give the company a competitive advantage and lead to higher performance.[8]

It is important to evaluate the importance of a company's resources, capabilities, and competencies to ascertain whether they are internal strategic factors—that is, particular strengths and weaknesses that will help determine the future of the company. This can be done by comparing measures of these factors with measures of (1) the company's past performance, (2) the company's key competitors, and (3) the industry as a whole. To the extent that a resource (such as a firm's cash situation), capability, or competency is significantly different from the firm's own past, its key competitors, or the industry average, that resource is likely to be a strategic factor and should be considered in strategic decisions.

Even though a distinctive competency is certainly considered to be a corporation's key strength, a key strength may not always be a distinctive competency. As competitors attempt to imitate another company's competency (especially during hypercompetition), what was once a distinctive competency becomes a minimum requirement to compete in the industry.[9] Even though the competency may still be a core competency and thus a strength, it is no longer unique. For example, when Maytag Company alone made high-quality home appliances, this ability was a distinctive competency. As other appliance makers imitated Maytag's quality control and design processes, this continued to be a key strength (that is, a core competency) of Maytag, but it was less and less a distinctive competency.

USING RESOURCES TO GAIN COMPETITIVE ADVANTAGE

Proposing that a company's sustained competitive advantage is primarily determined by its resource endowments, Grant proposes a five-step, resource-based approach to strategy analysis.

1. Identify and classify the firm's resources in terms of strengths and weaknesses.
2. Combine the firm's strengths into specific capabilities and core competencies.
3. Appraise the profit potential of these capabilities and competencies in terms of their potential for sustainable competitive advantage and the ability to harvest the profits resulting from their use. Are there any distinctive competencies?
4. Select the strategy that best exploits the firm's capabilities and competencies relative to external opportunities.
5. Identify resource gaps and invest in upgrading weaknesses.[10]

Where do these competencies come from? A corporation can gain access to a distinctive competency in four ways:

- It may be an asset endowment, such as a key patent, coming from the founding of the company. For example, Xerox grew on the basis of its original copying patent.
- It may be acquired from someone else. For example, Whirlpool bought a worldwide distribution system when it purchased Philips's appliance division.
- It may be shared with another business unit or alliance partner. For example, Apple Computer worked with a design firm to create the special appeal of its personal computers and iPods.
- It may be carefully built and accumulated over time within the company. For example, Honda carefully extended its expertise in small motor manufacturing from motorcycles to autos and lawnmowers.[11]

There is some evidence that the best corporations prefer organic internal growth over acquisitions. One study of large global companies identified firms that outperformed their peers on

both revenue growth and profitability over a decade. These excellent performers generated value from knowledge-intensive intangibles, such as copyrights, trade secrets, or strong brands, not from acquisitions.[12]

The desire to build or upgrade a core competency is one reason entrepreneurial and other fast-growing firms often tend to locate close to their competitors. They form *clusters*—geographic concentrations of interconnected companies and industries. Examples in the United States are computer technology in Silicon Valley in northern California; light aircraft in Wichita, Kansas; financial services in New York City; agricultural equipment in Iowa and Illinois; and home furniture in North Carolina. According to Michael Porter, clusters provide access to employees, suppliers, specialized information, and complementary products.[13] Being close to one's competitors makes it easier to measure and compare performance against rivals. Capabilities may thus be formed externally through a firm's network resources. An example is the presence of many venture capitalists located in Silicon Valley who provide financial support and assistance to high-tech startup firms in the region. Employees from competitive firms in these clusters often socialize. As a result, companies learn from each other while competing with each other. Interestingly, research reveals that companies with core competencies have little to gain from locating in a cluster with other firms and therefore do not do so. In contrast, firms with the weakest technologies, human resources, training programs, suppliers, and distributors are strongly motivated to cluster. They have little to lose and a lot to gain from locating close to their competitors.[14]

DETERMINING THE SUSTAINABILITY OF AN ADVANTAGE

Just because a firm is able to use its resources, capabilities, and competencies to develop a competitive advantage does not mean it will be able to sustain it. Two characteristics determine the sustainability of a firm's distinctive competency(ies): durability and imitability.

Durability is the rate at which a firm's underlying resources, capabilities, or core competencies depreciate or become obsolete. New technology can make a company's core competency obsolete or irrelevant. For example, Intel's skills in using basic technology developed by others to manufacture and market quality microprocessors was a crucial capability until management realized that the firm had taken current technology as far as possible with the Pentium chip. Without basic R&D of its own, it would slowly lose its competitive advantage to others. It thus formed a strategic alliance with HP to gain access to a needed technology.

Imitability is the rate at which a firm's underlying resources, capabilities, or core competencies can be duplicated by others. To the extent that a firm's distinctive competency gives it competitive advantage in the marketplace, competitors will do what they can to learn and imitate that set of skills and capabilities. Competitors' efforts may range from *reverse engineering* (which involves taking apart a competitor's product in order to find out how it works), to hiring employees from the competitor, to outright patent infringement. A core competency can be easily imitated to the extent that it is transparent, transferable, and replicable.

- **Transparency** is the speed with which other firms can understand the relationship of resources and capabilities supporting a successful firm's strategy. For example, Gillette has always supported its dominance in the marketing of razors with excellent R&D. A competitor could never understand how the Sensor or Mach 3 razor was produced simply by taking one apart. Gillette's razor design was very difficult to copy, partially because the manufacturing equipment needed to produce it was so expensive and complicated.
- **Transferability** is the ability of competitors to gather the resources and capabilities necessary to support a competitive challenge. For example, it may be very difficult for a wine

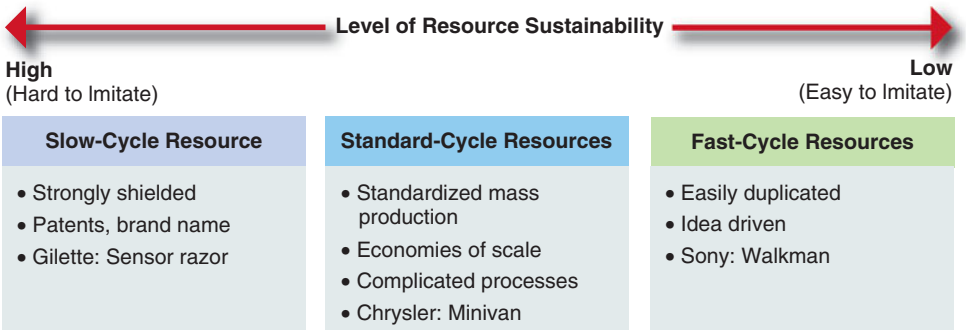
maker to duplicate a French winery's key resources of land and climate, especially if the imitator is located in Iowa.

- **Replicability** is the ability of competitors to use duplicated resources and capabilities to imitate the other firm's success. For example, even though many companies have tried to imitate Procter & Gamble's success with brand management by hiring brand managers away from P&G, they have often failed to duplicate P&G's success. The competitors failed to identify less visible P&G coordination mechanisms or to realize that P&G's brand management style conflicted with the competitor's own corporate culture.

It is relatively easy to learn and imitate another company's core competency or capability if it comes from **explicit knowledge**, that is, knowledge that can be easily articulated and communicated. This is the type of knowledge that competitive intelligence activities can quickly identify and communicate. **Tacit knowledge**, in contrast, is knowledge that is *not* easily communicated because it is deeply rooted in employee experience or in a corporation's culture.[15] Tacit knowledge is more valuable and more likely to lead to a sustainable competitive advantage than is explicit knowledge because it is much harder for competitors to imitate.[16] As explained by Michael Dell, founder of the Dell computer company, "others can understand what they do, but they can't do it."[17] The knowledge may be complex and combined with other types of knowledge in an unclear fashion in such a way that even management cannot clearly explain the competency.[18] Tacit knowledge is thus subject to a paradox. For a corporation to be successful and grow, its tacit knowledge must be clearly identified and codified if the knowledge is to be spread throughout the firm. Once tacit knowledge is identified and written down, however, it is easily imitable by competitors.[19] This forces companies to establish complex security systems to safeguard their key knowledge.

An organization's resources and capabilities can be placed on a continuum to the extent they are durable and can't be imitated (that is, aren't transparent, transferable, or replicable) by another firm. This **continuum of sustainability** is depicted in **Figure 5–1**. At one extreme are slow-cycle resources, which are sustainable because they are shielded by patents, geography, strong brand names, or tacit knowledge. These resources and capabilities are distinctive competencies because they provide a sustainable competitive advantage. Gillette's razor technology is a good example of a product built around slow-cycle resources. The other extreme includes fast-cycle resources, which face the highest imitation pressures because they are

FIGURE 5–1
Continuum of Resource Sustainability



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based on a concept or technology that can be easily duplicated, such as Sony's walkman. To the extent that a company has fast-cycle resources, the primary way it can compete successfully is through increased speed from lab to marketplace. Otherwise, it has no real sustainable competitive advantage.

With its low-cost position and innovative marketing strategy, Tata Motors appeared to have a competitive advantage in making and selling its new People's Car at the lowest price in the industry. Would this low-cost competitive advantage be sustainable? In terms of durability, the car's lack of safety or emissions equipment could be a disadvantage when India and other developing nations begin to require such technology. Given that most developing nations also have low labor costs, Tata's low wages could be easily imitated—probably fairly quickly. For example, the Renault—Nissan auto firm had already formed an alliance in 2008 with Indian motorcycle maker Bajal Auto to launch a $3,000 car in India in 2009.[20] Tata Motor's strategy of selling its new car in kit form was highly imitable, assuming that a competitor's car could be kept simple enough for dealers to assemble easily. Overall, the sustainability of Tata Motors' competitive advantage seemed fairly low, given the fast-cycle nature of its resources.

5.2 Business Models

When analyzing a company, it is helpful to learn what sort of business model it is following. This is especially important when analyzing Internet-based companies. A **business model** is a company's method for making money in the current business environment. It includes the key structural and operational characteristics of a firm—how it earns revenue and makes a profit. A business model is usually composed of five elements:

- Who it serves
- What it provides
- How it makes money
- How it differentiates and sustains competitive advantage
- How it provides its product/service[21]

The simplest business model is to provide a good or service that can be sold so that revenues exceed costs and expenses. Other models can be much more complicated. Some of the many possible business models are:

- **Customer solutions model:** IBM uses this model to make money not by selling IBM products, but by selling its expertise to improve its customers' operations. This is a consulting model.
- **Profit pyramid model:** General Motors offers a full line of automobiles in order to close out any niches where a competitor might find a position. The key is to get customers to buy in at the low-priced, low-margin entry point (Saturn's basic sedans) and move them up to high-priced, high-margin products (SUVs and pickup trucks) where the company makes its money.
- **Multi-component system/installed base model:** Gillette invented this classic model to sell razors at break-even pricing in order to make money on higher-margin razor blades. HP does the same with printers and printer cartridges. The product is thus a system, not just one product, with one component providing most of the profits.
- **Advertising model:** Similar to the multi-component system/installed base model, this model offers its basic product free in order to make money on advertising. Originating in

the newspaper industry, this model is used heavily in commercial radio and television. Internet-based firms, such as Google, offer free services to users in order to expose them to the advertising that pays the bills. This model is analogous to Mary Poppins' "spoonful of sugar (content) helps the medicine (advertising) go down."

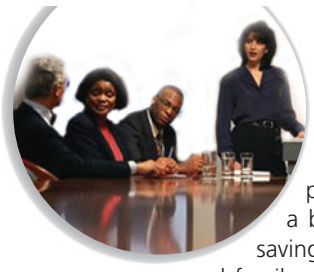
- **Switchboard model:** In this model a firm acts as an intermediary to connect multiple sellers to multiple buyers. Financial planners juggle a wide range of products for sale to multiple customers with different needs. This model has been successfully used by eBay and Amazon.com.
- **Time model:** Product R&D and speed are the keys to success in the time model. Being the first to market with a new innovation allows a pioneer like Sony to earn high margins. Once others enter the market with process R&D and lower margins, it's time to move on.
- **Efficiency model:** In this model a company waits until a product becomes standardized and then enters the market with a low-priced, low-margin product that appeals to the mass market. This model is used by Wal-Mart, Dell, and Southwest Airlines.
- **Blockbuster model:** In some industries, such as pharmaceuticals and motion picture studios, profitability is driven by a few key products. The focus is on high investment in a few products with high potential payoffs—especially if they can be protected by patents.
- **Profit multiplier model:** The idea of this model is to develop a concept that may or may not make money on its own but, through synergy, can spin off many profitable products. Walt Disney invented this concept by using cartoon characters to develop high-margin theme parks, merchandise, and licensing opportunities.
- **Entrepreneurial model:** In this model, a company offers specialized products/services to market niches that are too small to be worthwhile to large competitors but have the potential to grow quickly. Small, local brew pubs have been very successful in a mature industry dominated by Anheuser-Busch. This model has often been used by small high-tech firms that develop innovative prototypes in order to sell off the companies (without ever selling a product) to Microsoft or DuPont.
- **De Facto industry standard model:** In this model, a company offers products free or at a very low price in order to saturate the market and become the industry standard. Once users are locked in, the company offers higher-margin products using this standard. For example, Microsoft packaged Internet Explorer free with its Windows software in order to take market share from Netscape's Web browser.[22]

In order to understand how some of these business models work, it is important to learn where on the value chain the company makes its money. Although a company might offer a large number of products and services, one product line might contribute most of the profits. For example, ink and toner supplies for Hewlett-Packard's printers make up more than half of the company's profits while accounting for less than 25% of its sales.[23] For an example of a new business model at SmartyPig, see **Strategy Highlight 5.1**.

5.3 Value-Chain Analysis

A **value chain** is a linked set of value-creating activities that begin with basic raw materials coming from suppliers, moving on to a series of value-added activities involved in producing and marketing a product or service, and ending with distributors getting the final goods into the hands of the ultimate consumer. See **Figure 5–2** for an example of a typical value chain for a manufactured product. The focus of value-chain analysis is to examine the corporation in the context of the overall chain of value-creating activities, of which the firm may be only a small part.

STRATEGY highlight 5.1



A NEW BUSINESS MODEL AT SMARTYPIG

Are you having difficulty saving up for an important purchase like a trip or a car or a big-screen television? Would savings go faster if your friends and family could contribute to your savings account? What if they lived far away from your current bank?

Mike Ferari and Jon Gaskell of Des Moines, Iowa, are co-founders of SmartyPig, an online company that promotes savings through social networking. According to Gaskell, it's the 21st century version of a piggy bank—a new business model for motivating people to save money (instead of going into debt) for specific purchases. It's not a bank, but it works in partnership with West Bank of Des Moines, Iowa to provide an innovative service at its www.smartypig.com Web site.

- It creates an online way for a person to save money (and earn interest) for a specific goal, like a vacation, a big-screen TV, or even a house.
- It merges a savings account with digital social networking so that friends and family can contribute money to a saver's goal, such as a birthday or Christmas present. They can even view how close the saver is to reaching a goal.
- It creates rewards for reaching a savings goal by offering 5% discounts from merchants, like Best Buy or Circuit City, who offer the product being saved for.
- It offers the option for a saver to collect the money saved on an ATM debit card.

SmartyPig also offers gift cards for a friend or family member to purchase using e-mail or regular mail; cards that are not redeemable until an account has been opened and a goal has been selected.

The company's co-founders spent over a year dealing with regulatory and security issues. "The hurdles to make it work were huge, but it's the neatest savings device I've ever seen," reported Tom Stanberry, Chairman and CEO of SmartyPig's bank partner, West Bank.

SOURCE: "Online Company Promotes Savings," Saint Cloud Times (April 27, 2008), p. 11A; A. Kamenetz, "Making Banking Fun," Fast Company (September 2008); Corporate Web sites at www.smartpig.com and www.westbankiowa.com.

Very few corporations include a product's entire value chain. Ford Motor Company did when it was managed by its founder, Henry Ford I. During the 1920s and 1930s, the company owned its own iron mines, ore-carrying ships, and a small rail line to bring ore to its mile-long River Rouge plant in Detroit. Visitors to the plant would walk along an elevated walkway, where they could watch iron ore being dumped from the rail cars into huge furnaces. The resulting steel was poured and rolled out onto a moving belt to be fabricated into auto frames and parts while the visitors watched in awe. As visitors walked along the walkway, they observed an automobile being built piece by piece. Reaching the end of the moving line, the finished automobile was driven out of the plant into a vast adjoining parking lot. Ford trucks would then load the cars for delivery to dealers. Although the Ford dealers were not employees of the company, they had almost no power in the arrangement. Dealerships were awarded by the company and taken away if a dealer was at all disloyal. Ford Motor Company at that time was completely vertically integrated, that is, it controlled (usually by ownership) every stage of the value chain, from the iron mines to the retailers.

FIGURE 5–2
Typical Value Chain for a Manufactured Product

INDUSTRY VALUE-CHAIN ANALYSIS

The value chains of most industries can be split into two segments, *upstream* and *downstream* segments. In the petroleum industry, for example, *upstream* refers to oil exploration, drilling, and moving of the crude oil to the refinery, and *downstream* refers to refining the oil plus transporting and marketing gasoline and refined oil to distributors and gas station retailers. Even though most large oil companies are completely integrated, they often vary in the amount of expertise they have at each part of the value chain. Amoco, for example, had strong expertise downstream in marketing and retailing. British Petroleum, in contrast, was more dominant in upstream activities like exploration. That's one reason the two companies merged to form BP Amoco.

An industry can be analyzed in terms of the profit margin available at any point along the value chain. For example, the U.S. auto industry's revenues and profits are divided among many value-chain activities, including manufacturing, new and used car sales, gasoline retailing, insurance, after-sales service and parts, and lease financing. From a revenue standpoint, auto manufacturers dominate the industry, accounting for almost 60% of total industry revenues. Profits, however, are a different matter. Auto leasing has been the most profitable activity in the value chain, followed by insurance and auto loans. The core activities of manufacturing and distribution, however, earn significantly smaller shares of the total industry profits than they do of total revenues. For example, because auto sales have become marginally profitable, dealerships are now emphasizing service and repair. As a result of various differences along the industry value chain, manufacturers have moved aggressively into auto financing.[24] Ford, for example, generated $1.2 billion in profits from financial services in 2007 compared to a loss of $5 billion from automobiles, even though financing accounted for only 10.5% of the company's revenues!

In analyzing the complete value chain of a product, note that even if a firm operates up and down the entire industry chain, it usually has an area of expertise where its primary activities lie. A company's *center of gravity* is the part of the chain that is most important to the company and the point where its greatest expertise and capabilities lie—its core competencies. According to Galbraith, a company's center of gravity is usually the point at which the company started. After a firm successfully establishes itself at this point by obtaining a competitive advantage, one of its first strategic moves is to move forward or backward along the value chain in order to reduce costs, guarantee access to key raw materials, or to guarantee distribution.[25] This process, called *vertical integration,* is discussed in more detail in **Chapter 7**.

In the paper industry, for example, Weyerhauser's center of gravity is in the raw materials and primary manufacturing parts of the value chain as shown in **Figure 5–2**. Weyerhauser's expertise is in lumbering and pulp mills, which is where the company started. It integrated forward by using its wood pulp to make paper and boxes, but its greatest capability still lay in getting the greatest return from its lumbering activities. In contrast, P&G is primarily a consumer products company that also owned timberland and operated pulp mills. Its expertise is in the fabrication and distribution parts of the **Figure 5–2** value chain. P&G purchased these assets to guarantee access to the large quantities of wood pulp it needed to expand its disposable diaper, toilet tissue, and napkin products. P&G's strongest capabilities have always been in the downstream activities of product development, marketing, and brand management. It has never been as efficient in upstream paper activities as Weyerhauser. It had no real distinctive competency on that part of the value chain. When paper supplies became more plentiful (and competition got rougher), P&G gladly sold its land and mills to focus more on the part of the value chain where it could provide the greatest value at the lowest cost—creating and marketing innovative consumer products. As was the case with P&G's experience in the paper industry, it makes sense for a company to outsource any weak areas it may control internally on the industry value chain.

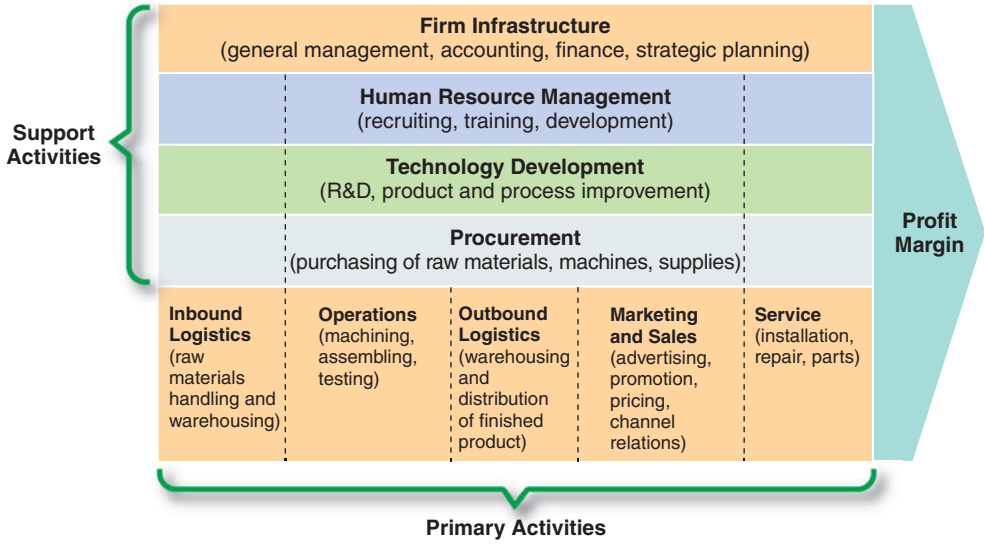
CORPORATE VALUE-CHAIN ANALYSIS

Each corporation has its own internal value chain of activities. See **Figure 5–3** for an example of a corporate value chain. Porter proposes that a manufacturing firm's *primary activities* usually begin with inbound logistics (raw materials handling and warehousing), go through an operations process in which a product is manufactured, and continue on to outbound logistics (warehousing and distribution), to marketing and sales, and finally to service (installation, repair, and sale of parts). Several *support activities,* such as procurement (purchasing), technology development (R&D), human resource management, and firm infrastructure (accounting, finance, strategic planning), ensure that the primary value chain activities operate effectively and efficiently. Each of a company's product lines has its own distinctive value chain. Because most corporations make several different products or services, an internal analysis of the firm involves analyzing a series of different value chains.

The systematic examination of individual value activities can lead to a better understanding of a corporation's strengths and weaknesses. According to Porter, "Differences among competitor value chains are a key source of competitive advantage."[26] Corporate value chain analysis involves the following three steps:

1. **Examine each product line's value chain in terms of the various activities involved in producing that product or service:** Which activities can be considered strengths (core competencies) or weaknesses (core deficiencies)? Do any of the strengths provide competitive advantage and can they thus be labeled distinctive competencies?
2. **Examine the "linkages" within each product line's value chain:** *Linkages* are the connections between the way one value activity (for example, marketing) is performed and the cost of performance of another activity (for example, quality control). In seeking ways for a corporation to gain competitive advantage in the marketplace, the same function can be performed in different ways with different results. For example, quality inspection of 100% of output by the workers themselves instead of the usual 10% by quality control

FIGURE 5–3
A Corporation's Value Chain



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inspectors might increase production costs, but that increase could be more than offset by the savings obtained from reducing the number of repair people needed to fix defective products and increasing the amount of salespeople's time devoted to selling instead of exchanging already-sold but defective products.

3. **Examine the potential synergies among the value chains of different product lines or business units:** Each value element, such as advertising or manufacturing, has an inherent economy of scale in which activities are conducted at their lowest possible cost per unit of output. If a particular product is not being produced at a high enough level to reach economies of scale in distribution, another product could be used to share the same distribution channel. This is an example of **economies of scope**, which result when the value chains of two separate products or services share activities, such as the same marketing channels or manufacturing facilities. The cost of joint production of multiple products can be lower than the cost of separate production.

5.4 Scanning Functional Resources and Capabilities

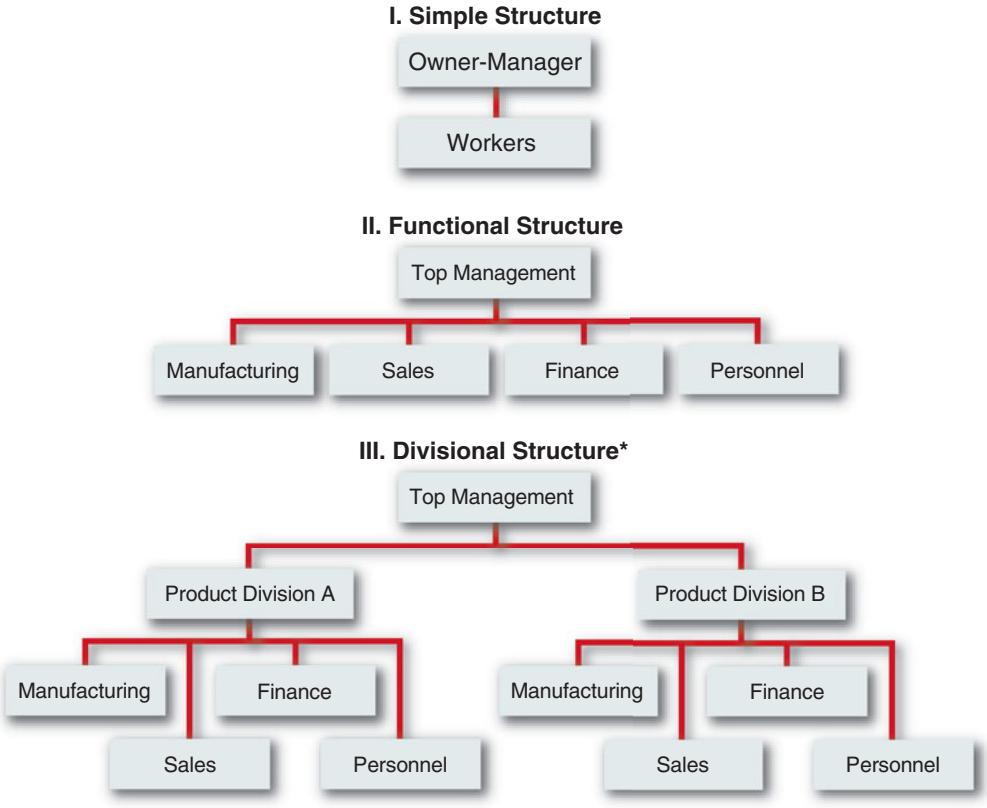
The simplest way to begin an analysis of a corporation's value chain is by carefully examining its traditional functional areas for potential strengths and weaknesses. Functional resources and capabilities include not only the financial, physical, and human assets in each area but also the ability of the people in each area to formulate and implement the necessary functional objectives, strategies, and policies. These resources and capabilities include the knowledge of analytical concepts and procedural techniques common to each area as well as the ability of the people in each area to use them effectively. If used properly, these resources and capabilities serve as strengths to carry out value-added activities and support strategic decisions. In addition to the usual business functions of marketing, finance, R&D, operations, human resources, and information systems/technology, we also discuss structure and culture as key parts of a business corporation's value chain.

BASIC ORGANIZATIONAL STRUCTURES

Although there is an almost infinite variety of structural forms, certain basic types predominate in modern complex organizations. **Figure 5–4** illustrates three basic **organizational structures**. The conglomerate structure is a variant of divisional structure and is thus not depicted as a fourth structure. Generally speaking, each structure tends to support some corporate strategies over others:

- **Simple structure** has no functional or product categories and is appropriate for a small, entrepreneur-dominated company with one or two product lines that operates in a reasonably small, easily identifiable market niche. Employees tend to be generalists and jacks-of-all-trades. In terms of stages of development (to be discussed in **Chapter 9**), this is a Stage I company.
- **Functional structure** is appropriate for a medium-sized firm with several product lines in one industry. Employees tend to be specialists in the business functions that are important to that industry, such as manufacturing, marketing, finance, and human resources. In terms of stages of development (discussed in **Chapter 9**), this is a Stage II company.
- **Divisional structure** is appropriate for a large corporation with many product lines in several related industries. Employees tend to be functional specialists organized according to product/market distinctions. General Motors, for example, groups its various auto lines into the separate divisions of Saturn, Chevrolet, Pontiac, Buick, and Cadillac. Management

FIGURE 5–4
Basic Organizational Structures



*Strategic Business Units and the conglomerate structure are variants of the divisional structure.

attempts to find some synergy among divisional activities through the use of committees and horizontal linkages. In terms of stages of development (to be discussed in **Chapter 9**), this is a Stage III company.

- **Strategic business units (SBUs)** are a modification of the divisional structure. Strategic business units are divisions or groups of divisions composed of independent product-market segments that are given primary responsibility and authority for the management of their own functional areas. *An SBU may be of any size or level, but it must have (1) a unique mission, (2) identifiable competitors, (3) an external market focus, and (4) control of its business functions.*[27] The idea is to decentralize on the basis of strategic elements rather than on the basis of size, product characteristics, or span of control and to create horizontal linkages among units previously kept separate. For example, rather than organize products on the basis of packaging technology like frozen foods, canned foods, and bagged foods, General Foods organized its products into SBUs on the basis of consumer-oriented menu segments: breakfast food, beverage, main meal, dessert, and pet foods. In terms of stages of development (to be discussed in **Chapter 9**), this is also a Stage III company.
- **Conglomerate structure** is appropriate for a large corporation with many product lines in several unrelated industries. A variant of the divisional structure, the conglomerate structure (sometimes called a holding company) is typically an assemblage of legally independent firms (subsidiaries) operating under one corporate umbrella but controlled through the subsidiaries' boards of directors. The unrelated nature of the subsidiaries

prevents any attempt at gaining synergy among them. In terms of stages of development (discussed in **Chapter 9**), this is also a Stage III company.

If the current basic structure of a corporation does not easily support a strategy under consideration, top management must decide whether the proposed strategy is feasible or whether the structure should be changed to a more advanced structure such as a matrix or network. (Advanced structural designs such as the matrix and network are discussed in **Chapter 9**.)

CORPORATE CULTURE: THE COMPANY WAY

There is an oft-told story of a person new to a company asking an experienced co-worker what an employee should do when a customer calls. The old-timer responded: "There are three ways to do any job—the right way, the wrong way, and the company way. Around here, we always do things the company way." In most organizations, the "company way" is derived from the corporation's culture. **Corporate culture** is the collection of beliefs, expectations, and values learned and shared by a corporation's members and transmitted from one generation of employees to another. The corporate culture generally reflects the values of the founder(s) and the mission of the firm.[28] It gives a company a sense of identity: "This is who we are. This is what we do. This is what we stand for." The culture includes the dominant orientation of the company, such as R&D at HP, high productivity at Nucor, customer service at Nordstrom, innovation at Google, or product quality at BMW. It often includes a number of informal work rules (forming the "company way") that employees follow without question. These work practices over time become part of a company's unquestioned tradition. The culture, therefore, reflects the company's values.

Corporate culture has two distinct attributes, intensity and integration.[29] *Cultural intensity* is the degree to which members of a unit accept the norms, values, or other culture content associated with the unit. This shows the culture's depth. Organizations with strong norms promoting a particular value, such as quality at BMW, have intensive cultures, whereas new firms (or those in transition) have weaker, less intensive cultures. Employees in an intensive culture tend to exhibit consistent behavior, that is, they tend to act similarly over time. *Cultural integration* is the extent to which units throughout an organization share a common culture. This is the culture's breadth. Organizations with a pervasive dominant culture may be hierarchically controlled and power-oriented, such as a military unit, and have highly integrated cultures. All employees tend to hold the same cultural values and norms. In contrast, a company that is structured into diverse units by functions or divisions usually exhibits some strong subcultures (for example, R&D versus manufacturing) and a less integrated corporate culture.

Corporate culture fulfills several important functions in an organization:

1. Conveys a sense of identity for employees.
2. Helps generate employee commitment to something greater than themselves.
3. Adds to the stability of the organization as a social system.
4. Serves as a frame of reference for employees to use to make sense of organizational activities and to use as a guide for appropriate behavior.[30]

Corporate culture shapes the behavior of people in a corporation, thus affecting corporate performance. For example, corporate cultures that emphasize the socialization of new employees have less employee turnover, leading to lower costs.[31] Because corporate cultures have a powerful influence on the behavior of people at all levels, they can strongly affect a corporation's ability to shift its strategic direction. A strong culture should not only promote survival, but it should also create the basis for a superior competitive position by increasing motivation

GLOBAL issue

MANAGING CORPORATE CULTURE FOR GLOBAL COMPETITIVE ADVANTAGE: ABB VERSUS MATSUSHITA

Zurich-based ABB Asea Brown Boveri AG is a worldwide builder of power plants, electrical equipment, and industrial factories in 140 countries. By establishing one set of multicultural values throughout its global operations, ABB's management believes that the company will gain an advantage over its rivals Siemens AG of Germany, France's Alcatel-Alsthom NV, and the U.S.'s General Electric Company. ABB is a company with no geographic base. Instead, it has many "home" markets that can draw on expertise from around the globe. ABB created a set of 500 global managers who could adapt to local cultures while executing ABB's global strategies. These people are multilingual and move around each of ABB's 5,000 profit centers in 140 countries. Their assignment is to cut costs, improve efficiency, and integrate local businesses with the ABB worldview.

Few multinational corporations are as successful as ABB in getting global strategies to work with local operations. In agreement with the resource-based view of the firm, the past Chairman of ABB, Percy Barnevik stated, "Our strength comes from pulling together. . . . If you can make this work real well, then you get a competitive edge out of the organization which is very, very difficult to copy."

Contrast ABB's globally-oriented corporate culture with the more Japanese-oriented parochial culture of Matsushita Electric Industrial Corporation (MEI) of Japan. Operating under the brand names of Panasonic and Technic, MEI is the third-largest electrical company in the world. Konosuke Matsushita founded the company in 1918. His management philosophy led to the company's success but became institutionalized in the corporate culture—a culture that was more focused on Japanese values than on cross-cultural globalization. As a result, MEI's corporate culture does not adapt well to local conditions. Not only is MEI's top management *exclusively* Japanese, its subsidiary managers are *overwhelmingly* Japanese. The company's distrust of non-Japanese managers in the United States and some European countries results in a "rice-paper ceiling" that prevents non-Japanese people from being promoted into MEI subsidiaries' top management. Foreign employees are often confused by the corporate philosophy that has not been adapted to suit local realities. MEI's corporate culture perpetuates a cross-cultural divide that separates the Japanese from the non-Japanese managers, leaving the non-Japanese managers feeling frustrated and undervalued. This divide prevents the flow of knowledge and experience from regional operations to the headquarters and may hinder MEI's ability to compete globally.

SOURCES: Summarized from J. Guyon, "ABB Fuses Units with One Set of Values," *Wall Street Journal* (October 2, 1996), p. A15 and N. Holden, "Why Globalizing with a Conservative Corporate Culture Inhibits Localization of Management: The Telling Case of Matsushita Electric," *International Journal of Cross Cultural Management*, Vol. 1, No. 1 (2001), pp. 53–72.

and facilitating coordination and control.[32] For example, a culture emphasizing constant renewal may help a company adapt to a changing, hypercompetitive environment.[33] To the extent that a corporation's distinctive competence is embedded in an organization's culture, it will be a form of tacit knowledge and very difficult for a competitor to imitate. The **Global Issue** feature shows the differences between ABB Asea Brown Boveri AG and Matsushita Electric in terms of how they manage their corporate cultures in a global industry.

A change in mission, objectives, strategies, or policies is not likely to be successful if it is in opposition to the accepted culture of a firm. Foot-dragging and even sabotage may result, as employees fight to resist a radical change in corporate philosophy. As with structure, if an organization's culture is compatible with a new strategy, it is an internal strength. But if the corporate culture is not compatible with the proposed strategy, it is a serious weakness. For example, when General Motors created a collaborative effort in 1996 among the three internal units of Saturn, International Operations, and Small Car Group for its proposed Delta Small Car Program, it caused a conflict with the company's long-standing cultural tradition of unit autonomy. GM employees found that they were expected to cooperate with other GM employees who did not share their views regarding vehicle requirements and architecture or of work

practices and processes. Significant cultural differences among the three units led to the program being abandoned in 2000.[34]

Corporate culture is also important when considering an acquisition. The merging of two dissimilar cultures, if not handled wisely, can create some serious internal conflicts. Procter & Gamble's management knew, for example, that their 2005 acquisition of Gillette might create some cultural problems. Even though both companies were strong consumer goods marketers, they each had a fundamental difference that led to many, subtle differences between the cultures: Gillette sold its razors, toothbrushes, and batteries to men; whereas, P&G sold its health and beauty aids to women. Art Lafley, P&G's CEO, admitted a year after the merger that it would take an additional year to 15 months to align the two companies.[35]

STRATEGIC MARKETING ISSUES

The marketing manager is a company's primary link to the customer and the competition. The manager, therefore, must be especially concerned with the market position and marketing mix of the firm as well as with the overall reputation of the company and its brands.

Market Position and Segmentation

Market position deals with the question, "Who are our customers?" It refers to the selection of specific areas for marketing concentration and can be expressed in terms of market, product, and geographic locations. Through market research, corporations are able to practice *market segmentation* with various products or services so that managers can discover what niches to seek, which new types of products to develop, and how to ensure that a company's many products do not directly compete with one another.

Marketing Mix

Marketing mix refers to the particular combination of key variables under a corporation's control that can be used to affect demand and to gain competitive advantage. These variables are product, place, promotion, and price. Within each of these four variables are several subvariables, listed in **Table 5–1**, that should be analyzed in terms of their effects on divisional and corporate performance.

TABLE 5–1 Marketing Mix Variables

Product	Place	Promotion	Price
Quality	Channels	Advertising	List price
Features	Coverage	Personal selling	Discounts
Options	Locations	Sales promotion	Allowances
Style	Inventory	Publicity	Payment periods
Brand name	Transport		Credit items
Packaging			
Sizes			
Services			
Warranties			
Returns			

SOURCE: KOTLER, PHILIP, MARKETING MANAGEMENT, 11th edition © 2003, p. 16. Reprinted by Pearson Education, Inc., Upper Saddle River, NJ.

Product Life Cycle

One of the most useful concepts in marketing, insofar as strategic management is concerned, is the **product life cycle**. As depicted in **Figure 5–5**, the product life cycle is a graph showing time plotted against the monetary sales of a product as it moves from introduction through growth and maturity to decline. This concept enables a marketing manager to examine the marketing mix of a particular product or group of products in terms of its position in its life cycle.

Brand and Corporate Reputation

A **brand** is a name given to a company's product which identifies that item in the mind of the consumer. Over time and with proper advertising, a brand connotes various characteristics in the consumers' minds. For example, Disney stands for family entertainment. Ivory suggests "pure" soap. BMW means high-performance autos. A brand can thus be an important corporate resource. If done well, a brand name is connected to the product to such an extent that a brand may stand for an entire product category, such as Kleenex for facial tissue. The objective is for the customer to ask for the brand name (Coke or Pepsi) instead of the product category (cola). The world's 10 most valuable brands in 2007 were Coca-Cola, Microsoft, IBM, GE, Nokia, Toyota, Intel, McDonald's, Disney, and Mercedes-Benz, in that order. According to *Business Week*, the value of the Coca-Cola brand is worth $65.3 billion.[36]

A *corporate brand* is a type of brand in which the company's name serves as the brand. Of the world's top 10 world brands listed previously, all are company names. The value of a corporate brand is that it typically stands for consumers' impressions of a company and can thus be extended onto products not currently offered—regardless of the company's actual expertise. For example, Caterpillar, a manufacturer of heavy earth-moving equipment, used consumer associations with the Caterpillar brand (*rugged*, *masculine*, *construction-related*) to market work boots. Thus, consumer impressions of a brand can suggest new product categories to enter even though a company may have no competencies in making or marketing that type of product or service.[37]

A **corporate reputation** is a widely held perception of a company by the general public. It consists of two attributes: (1) stakeholders' perceptions of a corporation's ability to produce quality goods and (2) a corporation's prominence in the minds of stakeholders.[38] A

FIGURE 5–5
Product Life Cycle

* The right end of the Growth stage is often called Competitive Turbulence because of price and distribution competition that shakes out the weaker competitors. For further information, see C. R. Wasson, *Dynamic Competitive Strategy and Product Life Cycles*. 3rd ed. (Austin, TX: Austin Press, 1978).

good corporate reputation can be a strategic resource. It can serve in marketing as both a signal and an entry barrier. It contributes to its goods having a price premium.[39] Reputation is especially important when the quality of a company's product or service is not directly observable and can be learned only through experience. For example, retail stores are willing to stock a new product from P&G or Anheuser-Busch because they know that both companies market only good-quality products that are highly advertised. Like tacit knowledge, reputation tends to be long-lasting and hard for others to duplicate—thus providing sustainable competitive advantage.[40] It can have a significant impact on a firm's stock price.[41] Research reveals a positive relationship between corporate reputation and financial performance.[42]

STRATEGIC FINANCIAL ISSUES

A financial manager must ascertain the best sources of funds, uses of funds, and control of funds. All strategic issues have financial implications. Cash must be raised from internal or external (local and global) sources and allocated for different uses. The flow of funds in the operations of an organization must be monitored. To the extent that a corporation is involved in international activities, currency fluctuations must be dealt with to ensure that profits aren't wiped out by the rise or fall of the dollar versus the yen, euro, or other currencies. Benefits in the form of returns, repayments, or products and services must be given to the sources of outside financing. All these tasks must be handled in a way that complements and supports overall corporate strategy. A firm's capital structure (amounts of debt and equity) can influence its strategic choices. For example, increased debt tends to increase risk aversion and decrease the willingness of management to invest in R&D.[43]

Financial Leverage

The mix of externally generated short-term and long-term funds in relation to the amount and timing of internally generated funds should be appropriate to the corporate objectives, strategies, and policies. The concept of **financial leverage** (the ratio of total debt to total assets) is helpful in describing how debt is used to increase the earnings available to common shareholders. When the company finances its activities by sales of bonds or notes instead of through stock, the earnings per share are boosted: the interest paid on the debt reduces taxable income, but fewer shareholders share the profits than if the company had sold more stock to finance its activities. The debt, however, does raise the firm's break-even point above what it would have been if the firm had financed from internally generated funds only. High leverage may therefore be perceived as a corporate strength in times of prosperity and ever-increasing sales, or as a weakness in times of a recession and falling sales. This is because leverage acts to magnify the effect on earnings per share of an increase or decrease in dollar sales. Research indicates that greater leverage has a positive impact on performance for firms in stable environments, but a negative impact for firms in dynamic environments.[44]

Capital Budgeting

Capital budgeting is the analyzing and ranking of possible investments in fixed assets such as land, buildings, and equipment in terms of the additional outlays and additional receipts that will result from each investment. A good finance department will be able to prepare such capital budgets and to rank them on the basis of some accepted criteria or *hurdle rate* (for example, years to pay back investment, rate of return, or time to break-even point) for the purpose of strategic decision making. Most firms have more than one hurdle rate and vary it as a function of the type of project being considered. Projects with high strategic significance, such as entering new markets or defending market share, will often have low hurdle rates.[45]

STRATEGIC RESEARCH AND DEVELOPMENT (R&D) ISSUES

The R&D manager is responsible for suggesting and implementing a company's technological strategy in light of its corporate objectives and policies. The manager's job, therefore, involves (1) choosing among alternative new technologies to use within the corporation, (2) developing methods of embodying the new technology in new products and processes, and (3) deploying resources so that the new technology can be successfully implemented.

R&D Intensity, Technological Competence, and Technology Transfer

The company must make available the resources necessary for effective research and development. A company's **R&D intensity** (its spending on R&D as a percentage of sales revenue) is a principal means of gaining market share in global competition. The amount spent on R&D often varies by industry. For example, the U.S. computer software industry traditionally spends 13.5% of its sales dollar for R&D, whereas the paper and forest products industry spends only 1.0%.[46] A good rule of thumb for R&D spending is that a corporation should spend at a "normal" rate for that particular industry unless its strategic plan calls for unusual expenditures.

Simply spending money on R&D or new projects does not mean, however, that the money will produce useful results. For example, Pharmacia Upjohn spent more of its revenues on research than any other company in any industry (18%), but it was ranked low in innovation.[47] A company's R&D unit should be evaluated for **technological competence** in both the development and the use of innovative technology. Not only should the corporation make a consistent research effort (as measured by reasonably constant corporate expenditures that result in usable innovations), it should also be proficient in managing research personnel and integrating their innovations into its day-to-day operations. A company should also be proficient in **technology transfer**, the process of taking a new technology from the laboratory to the marketplace. Aerospace parts maker Rockwell Collins, for example, is a master of developing new technology, such as the "heads-up display" (transparent screens in an airplane cockpit that tell pilots speed, altitude, and direction), for the military and then using it in products built for the civilian market.[48]

R&D Mix

Basic R&D is conducted by scientists in well-equipped laboratories where the focus is on theoretical problem areas. The best indicators of a company's capability in this area are its patents and research publications. *Product R&D* concentrates on marketing and is concerned with product or product-packaging improvements. The best measurements of ability in this area are the number of successful new products introduced and the percentage of total sales and profits coming from products introduced within the past five years. *Engineering (or process) R&D* is concerned with engineering, concentrating on quality control, and the development of design specifications and improved production equipment. A company's capability in this area can be measured by consistent reductions in unit manufacturing costs and by the number of product defects.

Most corporations will have a mix of basic, product, and process R&D, which varies by industry, company, and product line. The balance of these types of research is known as the **R&D mix** and should be appropriate to the strategy being considered and to each product's life cycle. For example, it is generally accepted that product R&D normally dominates the early stages of a product's life cycle (when the product's optimal form and features are still being debated), whereas process R&D becomes especially important in the later stages (when the product's design is solidified and the emphasis is on reducing costs and improving quality).

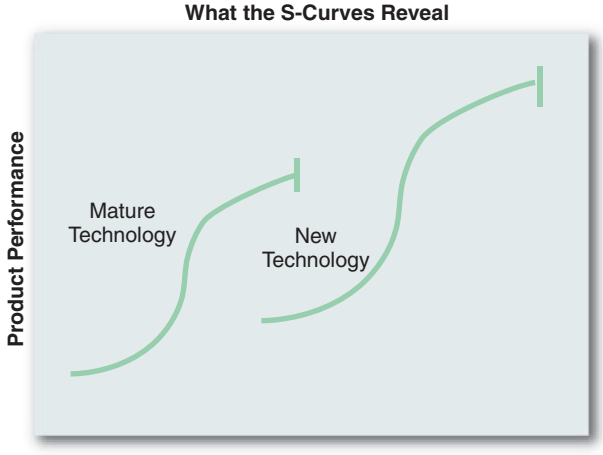
Impact of Technological Discontinuity on Strategy

The R&D manager must determine when to abandon present technology and when to develop or adopt new technology. Richard Foster of McKinsey and Company states that the displacement of one technology by another (**technological discontinuity**) is a frequent and strategically important phenomenon. Such a discontinuity occurs when a new technology cannot simply be used to enhance the current technology, but actually substitutes for that technology to yield better performance. For each technology within a given field or industry, according to Foster, the plotting of product performance against research effort/expenditures on a graph results in an S-shaped curve. He describes the process depicted in **Figure 5–6**:

> *Early in the development of the technology a knowledge base is being built and progress requires a relatively large amount of effort. Later, progress comes more easily. And then, as the limits of that technology are approached, progress becomes slow and expensive. That is when R&D dollars should be allocated to technology with more potential. That is also—not so incidentally—when a competitor who has bet on a new technology can sweep away your business or topple an entire industry.*[49]

Computerized information technology is currently on the steep upward slope of its S-curve in which relatively small increments in R&D effort result in significant improvement in performance. This is an example of *Moore's Law*, which states that silicon chips (microprocessors) double in complexity every 18 months.[50] The presence of a technological discontinuity in the world's steel industry during the 1960s explains why the large capital expenditures by U.S. steel companies failed to keep them competitive with the Japanese firms that adopted the new technologies. As Foster points out, "History has shown that as one technology nears the end of its S-curve, competitive leadership in a market generally changes hands."[51]

FIGURE 5–6
Technological Discontinuity



In the corporate planning process, it is generally assumed that incremental progress in technology will occur. But past developments in a given technology cannot be extrapolated into the future because every technology has its limits. The key to competitiveness is to determine when to shift resources to a technology that has more potential.

SOURCE: *From "Are You Investing in the Wrong Technology?" P. Pascarella,* Industry Week, *July 25, 1983. Reprinted by permission of Penton Media, Inc.*

Christensen explains in *The Innovator's Dilemma* why this transition occurs when a "disruptive technology" enters an industry. In a study of computer disk drive manufacturers, he explains that established market leaders are typically reluctant to move in a timely manner to a new technology. This reluctance to switch technologies (even when the firm is aware of the new technology and may have even invented it!) is because the resource allocation process in most companies gives priority to those projects (typically based on the old technology) with the greatest likelihood of generating a good return on investment—those projects appealing to the firm's current customers (whose products are also based on the characteristics of the old technology). For example, in the 1980s a disk drive manufacturer's customers (PC manufacturers) wanted a better (faster) 5 1/4″ drive with greater capacity. These PC makers were not interested in the new 3 1/2″ drives based on the new technology because (at that time) the smaller drives were slower and had less capacity. Smaller size was irrelevant since these companies primarily made desk top personal computers which were designed to hold large drives.

The new technology is generally riskier and of little appeal to the current customers of established firms. Products derived from the new technology are more expensive and do not meet the customers' requirements—requirements based on the old technology. New entrepreneurial firms are typically more interested in the new technology because it is one way to appeal to a developing market niche in a market currently dominated by established companies. Even though the new technology may be more expensive to develop, it offers performance improvements in areas that are attractive to this small niche, but of no consequence to the customers of the established competitors.

This was the case with the entrepreneurial manufacturers of 3 1/2″ disk drives. These smaller drives appealed to the PC makers who were trying to increase their small PC market share by offering laptop computers. Size and weight were more important to these customers than were capacity and speed. By the time the new technology was developed to the point that the 3 1/2″ drive matched and even surpassed the 5 1/4″ drive in terms of speed and capacity (in addition to size and weight), it was too late for the established 5 1/4″ disk drive firms to switch to the new technology. Once their customers begin demanding smaller products using the new technology, the established firms were unable to respond quickly and lost their leadership position in the industry. They were able to remain in the industry (with a much reduced market share) only if they were able to utilize the new technology to be competitive in the new product line.[52]

The same phenomenon can be seen in many product categories ranging from flat-panel display screens to railroad locomotives to digital photography to musical recordings. For example, George Heilmeier created the first practical liquid-crystal display (LCD) in 1964 at RCA Labs. RCA unveiled the new display in 1968 with much fanfare about LCDs being the future of TV sets, but then refused to fund further development of the new technology. In contrast, Japanese television and computer manufacturers invested in long-term development of LCDs. Today, Japanese, Korean, and Taiwanese companies dominate the $39 billion LCD business and RCA no longer makes televisions. Interestingly, Heilmeier received the Kyoto Prize in 2005 for his LCD invention.[53]

STRATEGIC OPERATIONS ISSUES

The primary task of the operations (manufacturing or service) manager is to develop and operate a system that will produce the required number of products or services, with a certain quality, at a given cost, within an allotted time. Many of the key concepts and techniques popularly used in manufacturing can be applied to service businesses.

In very general terms, manufacturing can be intermittent or continuous. In *intermittent systems* (job shops), the item is normally processed sequentially, but the work and sequence

of the process vary. An example is an auto body repair shop. At each location, the tasks determine the details of processing and the time required for them. These job shops can be very labor intensive. For example, a job shop usually has little automated machinery and thus a small amount of fixed costs. It has a fairly low break-even point, but its variable cost line (composed of wages and costs of special parts) has a relatively steep slope. Because most of the costs associated with the product are variable (many employees earn piece-rate wages), a job shop's variable costs are higher than those of automated firms. Its advantage over other firms is that it can operate at low levels and still be profitable. After a job shop's sales reach break-even, however, the huge variable costs as a percentage of total costs keep the profit per unit at a relatively low level. In terms of strategy, this firm should look for a niche in the marketplace for which it can produce and sell a reasonably small quantity of custom-made goods.

In contrast, *continuous systems* are those laid out as lines on which products can be continuously assembled or processed. An example is an automobile assembly line. A firm using continuous systems invests heavily in fixed investments such as automated processes and highly sophisticated machinery. Its labor force, relatively small but highly skilled, earns salaries rather than piece-rate wages. Consequently, this firm has a high amount of fixed costs. It also has a relatively high break-even point, but its variable cost line rises slowly. This is an example of **operating leverage**, the impact of a specific change in sales volume on net operating income. The advantage of high operating leverage is that once the firm reaches break-even, its profits rise faster than do those of less automated firms having lower operating leverage. Continuous systems reap benefits from economies of scale. In terms of strategy, this firm needs to find a high-demand niche in the marketplace for which it can produce and sell a large quantity of goods. However, a firm with high operating leverage is likely to suffer huge losses during a recession. During an economic downturn, the firm with less automation and thus less leverage is more likely to survive comfortably because a drop in sales primarily affects variable costs. It is often easier to lay off labor than to sell off specialized plants and machines.

Experience Curve

A conceptual framework that many large corporations have used successfully is the experience curve (originally called the learning curve). The **experience curve** suggests that unit production costs decline by some fixed percentage (commonly 20%–30%) each time the total accumulated volume of production in units doubles. The actual percentage varies by industry and is based on many variables: the amount of time it takes a person to learn a new task, scale economies, product and process improvements, and lower raw materials cost, among others. For example, in an industry with an 85% experience curve, a corporation might expect a 15% reduction in unit costs for every doubling of volume. The total costs per unit can be expected to drop from $100 when the total production is 10 units, to $85 ($100 x 85%) when production increases to 20 units, and to $72.25 ($85 x 85%) when it reaches 40 units. Achieving these results often means investing in R&D and fixed assets; higher fixed costs and less flexibility thus result. Nevertheless the manufacturing strategy is one of building capacity ahead of demand in order to achieve the lower unit costs that develop from the experience curve. On the basis of some future point on the experience curve, the corporation should price the product or service very low to preempt competition and increase market demand. The resulting high number of units sold and high market share should result in high profits, based on the low unit costs.

Management commonly uses the experience curve in estimating the production costs of (1) a product never before made with the present techniques and processes or (2) current products produced by newly introduced techniques or processes. The concept was first applied in the airframe industry and can be applied in the service industry as well. For example, a cleaning company can reduce its costs per employee by having its workers use the same equipment and techniques to clean many adjacent offices in one office building rather

than just cleaning a few offices in multiple buildings. Although many firms have used experience curves extensively, an unquestioning acceptance of the industry norm (such as 80% for the airframe industry or 70% for integrated circuits) is very risky. The experience curve of the industry as a whole might not hold true for a particular company for a variety of reasons.[54]

Flexible Manufacturing for Mass Customization

The use of large, continuous, mass-production facilities to take advantage of experience-curve economies has recently been criticized. The use of **C**omputer-**A**ssisted **D**esign and **C**omputer-**A**ssisted **M**anufacturing (CAD/CAM) and robot technology means that learning times are shorter and products can be economically manufactured in small, customized batches in a process called *mass customization*—the low-cost production of individually customized goods and services.[55] Economies of scope (in which common parts of the manufacturing activities of various products are combined to gain economies even though small numbers of each product are made) replace **Economies of scale** (in which unit costs are reduced by making large numbers of the same product) in flexible manufacturing. *Flexible manufacturing* permits the low-volume output of custom-tailored products at relatively low unit costs through economies of scope. It is thus possible to have the cost advantages of continuous systems with the customer-oriented advantages of intermittent systems. The auto maker, BMW, for example, uses flexible manufacturing to customize cars to suit each buyer's preference. It replaced its two assembly lines in its Spartanburg, South Carolina, plant with one flexible assembly line in 2006. According to spokesperson Bunny Richardson, "Until now, if we wanted to introduce an additional model, we'd have to construct a new line."[56]

STRATEGIC HUMAN RESOURCE (HRM) ISSUES

The primary task of the manager of human resources is to improve the match between individuals and jobs. Research indicates that companies with good HRM practices have higher profits and a better survival rate than do firms without these practices.[57] A good HRM department should know how to use attitude surveys and other feedback devices to assess employees' satisfaction with their jobs and with the corporation as a whole. HRM managers should also use job analysis to obtain job description information about what each job needs to accomplish in terms of quality and quantity. Up-to-date job descriptions are essential not only for proper employee selection, appraisal, training, and development for wage and salary administration, and for labor negotiations, but also for summarizing the corporate-wide human resources in terms of employee-skill categories. Just as a company must know the number, type, and quality of its manufacturing facilities, it must also know the kinds of people it employs and the skills they possess. The best strategies are meaningless if employees do not have the skills to carry them out or if jobs cannot be designed to accommodate the available workers. IBM, Procter & Gamble, and Hewlett-Packard, for example, use employee profiles to ensure that they have the best mix of talents to implement their planned strategies. Because project managers at IBM are now able to scan the company's databases to identify employee capabilities and availability, the average time needed to assemble a team has declined 20% for a savings of $500 million overall.[58]

Increasing Use of Teams

Management is beginning to realize that it must be more flexible in its utilization of employees in order for human resources to be classified as a strength. Human resource managers, therefore, need to be knowledgeable about work options such as part-time work, job sharing, flex-time,

extended leaves, and contract work, and especially about the proper use of teams. Over two-thirds of large U.S. companies are successfully using *autonomous (self-managing) work teams* in which a group of people work together without a supervisor to plan, coordinate, and evaluate their own work.[59] Northern Telecom found productivity and quality to increase with work teams to such an extent that it was able to reduce the number of quality inspectors by 40%.[60]

As a way to move a product more quickly through its development stage, companies like Motorola, Chrysler, NCR, Boeing, and General Electric are using *cross-functional work teams*. Instead of developing products in a series of steps—beginning with a request from sales, which leads to design, then to engineering and on to purchasing, and finally to manufacturing (and often resulting in a costly product rejected by the customer)—companies are tearing down the traditional walls separating the departments so that people from each discipline can get involved in projects early on. In a process called *concurrent engineering*, the once-isolated specialists now work side by side and compare notes constantly in an effort to design cost-effective products with features customers want. Taking this approach enabled Chrysler Corporation to reduce its product development cycle from 60 to 36 months.[61] For such cross-functional work teams to be successful, the groups must receive training and coaching. Otherwise, poorly implemented teams may worsen morale, create divisiveness, and raise the level of cynicism among workers.[62]

Virtual teams are groups of geographically and/or organizationally dispersed coworkers that are assembled using a combination of telecommunications and information technologies to accomplish an organizational task.[63] In the U.S. alone, more than half of companies having over 5,000 employees use virtual teams involving around 8.4 million people.[64] According to the Gartner Group, more than 60% of professional employees now work in virtual teams.[65] Internet, intranet, and extranet systems are combining with other new technologies, such as desktop video conferencing and collaborative software, to create a new workplace in which teams of workers are no longer restrained by geography, time, or organizational boundaries. This technology allows about 12% of the U.S. workforce, who have no permanent office at their companies, to do team projects over the Internet and report to a manager thousands of miles away. More than 20 million people in the U.S. are engaged in telecommuting.[66] Charles Grantham of Work Design Collaborative predicts that 40% of the workforce will be working remotely by 2012.[67]

As more companies outsource some of the activities previously conducted internally, the traditional organizational structure is being replaced by a series of virtual teams, which rarely, if ever, meet face-to-face. Such teams may be established as temporary groups to accomplish a specific task or may be more permanent to address continuing issues such as strategic planning. Membership on these teams is often fluid, depending upon the task to be accomplished. They may include not only employees from different functions within a company, but also members of various stakeholder groups, such as suppliers, customers, and law or consulting firms. The use of virtual teams to replace traditional face-to-face work groups is being driven by five trends:

1. Flatter organizational structures with increasing cross-functional coordination need
2. Turbulent environments requiring more inter-organizational cooperation
3. Increasing employee autonomy and participation in decision making
4. Higher knowledge requirements derived from a greater emphasis on service
5. Increasing globalization of trade and corporate activity[68]

Union Relations and Temporary/Part-Time Workers

If the corporation is unionized, a good human resource manager should be able to work closely with the union. Even though union membership had dropped to only 12.1% of the U.S. workforce by 2007 compared to 20.1% in 1983, it still included 15.7 million people. Nevertheless,

only 7.5% of the 108,714 million private sector employees belonged to a union (compared to 35.9% of public sector employees).[69] To save jobs, U.S. unions are increasingly willing to support new strategic initiatives and employee involvement programs. For example, United Steel Workers hired Ron Bloom, an investment banker, to propose a strategic plan to make Goodyear Tire & Rubber globally competitive in a way that would preserve as many jobs as possible. In a recent contract, the union gave up $1.15 billion in wage and benefit concessions over three years in return for a promise by Goodyear's top management to invest in 12 of its 14 U.S. factories, to limit imports from its factories in Brazil and Asia, and to maintain 85% of its 19,000-person workforce. The company also agreed to aggressively restructure the firm's $5 billion debt. According to Bloom, "We told Goodyear, 'We'll make you profitable, but you're going to adopt this strategy.'. . . We think the company should be a patient, long-term builder of value for the employees and shareholders."[70]

Outside the United States, the average proportion of unionized workers among major industrialized nations is around 50%. European unions tend to be militant, politically oriented, and much less interested in working with management to increase efficiency. Nationwide strikes can occur quickly. In contrast, Japanese unions are typically tied to individual companies and are usually supportive of management. These differences among countries have significant implications for the management of multinational corporations.

To increase flexibility, avoid layoffs, and reduce labor costs, corporations are using more temporary (also known as contingent) workers. Over 90% of U.S. and European firms use temporary workers in some capacity; 43% use them in professional and technical functions.[71] Approximately 13% of the U.S. workforce are part-time workers. The percentage is even higher in Japan, where 26% of workers are part-time, and in the Netherlands, where 36% of all employees work part-time.[72] Labor unions are concerned that companies use temps to avoid hiring costlier unionized workers. At United Parcel Service, for example, 80% of the jobs created from 1993 to 1997 were staffed by part-timers, whose pay rates hadn't changed since 1982. Fully 10% of the company's 128,000 part-timers worked 30 hours or more per week, but were still paid at a lower rate than were full-time employees.[73]

Quality of Work Life and Human Diversity

Human resource departments have found that to reduce employee dissatisfaction and unionization efforts (or, conversely, to improve employee satisfaction and existing union relations), they must consider the *quality of work life* in the design of jobs. Partially a reaction to the traditionally heavy emphasis on technical and economic factors in job design, quality of work life emphasizes improving the human dimension of work. The knowledgeable human resource manager, therefore, should be able to improve the corporation's quality of work life by (1) introducing participative problem solving, (2) restructuring work, (3) introducing innovative reward systems, and (4) improving the work environment. It is hoped that these improvements will lead to a more participative corporate culture and thus higher productivity and quality products. Ford Motor Company, for example, rebuilt and modernized its famous River Rouge plant using flexible equipment and new processes. Employees work in teams and use Internet-connected PCs on the shop floor to share their concerns instantly with suppliers or product engineers. Workstations were redesigned to make them more ergonomic and reduce repetitive-strain injuries. "If you feel good while you're working, I think quality and productivity will increase, and Ford thinks that too, otherwise, they wouldn't do this," observed Jerry Sullivan, president of United Auto Workers Local 600.[74]

Companies are also discovering that by redesigning their plants and offices for improved energy efficiency, they can receive a side effect of improving their employees' quality of work life—thus raising labor productivity. See the **Environmental Sustainability Issue** feature to learn how improved energy efficiency can not only cut costs, but also boost employee morale.

ENVIRONMENTAL sustainability issue

USING ENERGY EFFICIENCY FOR COMPETITIVE ADVANTAGE AND QUALITY OF WORK LIFE

Amory Lovins, Co-founder and Chairman of the Rocky Mountain Institute, works to educate business executives on how the efficient use of energy can lead not only to lower costs, but also to competitive advantage and increased labor productivity. His Rocky Mountain Institute is a nonprofit organization that develops and implements programs for energy and resource efficiency. According to Lovins:

> *In my team's latest redesigns for $30 billion worth of facilities in 29 sectors, we consistently found about 30 to 60 percent energy savings that could be captured through retrofits, which paid for themselves in two to three years. In new facilities, 40 to 90 percent savings could be gleaned—and with nearly always lower capital cost.*

Lovins' Rocky Mountain Institute promotes the use of *micropower*, on-site or decentralized energy production, such as waste-heat, or gas-fired cogeneration, wind and solar power, geothermal, small hydro, and waste- or biomass-fueled plants. Lovins points out that a sixth of the world's electricity and a third of new electricity now comes from micropower because it's cheaper with lower financial risk.

Lovins points out that energy redesigns often have side effects that may be far more valuable than the direct savings. For example, a typical office pays around 160 times more in payroll than for energy. According to Lovins, his programs routinely get a 6% to 16% increase gain in labor productivity in more efficient buildings having improved thermal, visual, and acoustic comfort. "When people can see what they are doing, hear themselves think, breathe cleaner air, and feel more comfortable, they do more and better work," says Lovins.

SOURCE: Material based on M. Hirschland, J. M. Oppenheim, and A. P. Webb, "Using Energy More Efficiently: An Interview with the Rocky Mountain Institute's Amory Lovins," *McKinsey Quarterly* (July 2008), pp. 1–7.

Human diversity refers to the mix in the workplace of people from different races, cultures, and backgrounds. Realizing that the demographics are changing toward an increasing percentage of minorities and women in the U.S. workforce, companies are now concerned with hiring and promoting people without regard to ethnic background. Research does indicate that an increase in racial diversity leads to an increase in firm performance.[75] In a survey of 131 leading European companies, 67.2% stated that a diverse work force can provide competitive advantage.[76] A manager from Nestlé stated: "To deliver products that meet the needs of individual consumers, we need people who respect other cultures, embrace diversity, and never discriminate on any basis."[77] Good human resource managers should be working to ensure that people are treated fairly on the job and not harassed by prejudiced co-workers or managers. Otherwise, they may find themselves subject to lawsuits. Coca-Cola Company, for example, agreed to pay $192.5 million because of discrimination against African-American salaried employees in pay, promotions, and evaluations from 1995 and 2000. According to Chairman and CEO Douglas Daft, "Sometimes things happen in an unintentional manner. And I've made it clear that can't happen anymore."[78]

An organization's human resources may be a key to achieving a sustainable competitive advantage. Advances in technology are copied almost immediately by competitors around the world. People, however, are not as willing to move to other companies in other countries. This means that the only long-term resource advantage remaining to corporations operating in the industrialized nations may lie in the area of skilled human resources.[79] Research does reveal that competitive strategies are more successfully executed in those companies with a high level of commitment to their employees than in those firms with less commitment.[80]

STRATEGIC INFORMATION SYSTEMS/TECHNOLOGY ISSUES

The primary task of the manager of information systems/technology is to design and manage the flow of information in an organization in ways that improve productivity and decision making. Information must be collected, stored, and synthesized in such a manner that it will answer important operating and strategic questions. A corporation's information system can be a strength or a weakness in multiple areas of strategic management. It can not only aid in environmental scanning and in controlling a company's many activities, it can also be used as a strategic weapon in gaining competitive advantage.

Impact on Performance

Information systems/technology offers four main contributions to corporate performance. *First*, (beginning in the 1970s with mainframe computers) it is used to automate existing back-office processes, such as payroll, human resource records, accounts payable and receivable, and to establish huge databases. *Second*, (beginning in the 1980s) it is used to automate individual tasks, such as keeping track of clients and expenses, through the use of personal computers with word processing and spreadsheet software. Corporate databases are accessed to provide sufficient data to analyze the data and create what-if scenarios. These first two contributions tend to focus on reducing costs. *Third,* (beginning in the 1990s) it is used to enhance key business functions, such as marketing and operations. This third contribution focuses on productivity improvements. The system provides customer support and help in distribution and logistics. For example, Federal Express found that by allowing customers to directly access its package-tracking database via its Internet Web site instead of their having to ask a human operator, the company saved up to $2 million annually.[81] Business processes are analyzed to increase efficiency and productivity via reengineering. Enterprise resource planning (ERP) application software, such as SAP, PeopleSoft, Oracle, Baan, and J.D. Edwards, (discussed further in **Chapter 10**) is used to integrate worldwide business activities so that employees need to enter information only once and that information is available to all corporate systems (including accounting) around the world. *Fourth*, (beginning in 2000) it is used to develop competitive advantage. For example, American Hospital Supply (AHS), a leading manufacturer and distributor of a broad line of products for doctors, laboratories, and hospitals, developed an order entry distribution system that directly linked the majority of its customers to AHS computers. The system was successful because it simplified ordering processes for customers, reduced costs for both AHS and the customer, and allowed AHS to provide pricing incentives to the customer. As a result, customer loyalty was high and AHS's share of the market became large.

A current trend in corporate information systems/technology is the increasing use of the Internet for marketing, intranets for internal communication, and extranets for logistics and distribution. An *intranet* is an information network within an organization that also has access to the external worldwide Internet. Intranets typically begin as ways to provide employees with company information such as lists of product prices, fringe benefits, and company policies. They are then converted into extranets for supply chain management. An *extranet* is an information network within an organization that is available to key suppliers and customers. The key issue in building an extranet is the creation of "fire walls" to block extranet users from accessing the firm's or other users' confidential data. Once this is accomplished, companies can allow employees, customers, and suppliers to access information and conduct business on the Internet in a completely automated manner. By connecting these groups, companies hope to obtain a competitive advantage by reducing the time needed to design and bring new products to market, slashing inventories, customizing manufacturing, and entering new markets.[82]

A recent development in information systems/technology is Web 2.0. *Web 2.0* refers to the use of wikis, blogs, RSS (Really Simple Syndication), social networks (e.g., MySpace and Facebook), podcasts, and mash-ups through company Web sites to forge tighter links with customers and suppliers and to engage employees more successfully. A 2008 survey by McKinsey

revealed the percentage of companies using individual Web 2.0 technologies to be Web services (58%), blogs (34%), RSS (33%), wikis (32%), podcasts (29%), social networking (28%), peer-to-peer (18%), and mash-ups (10%). The most heavily used tool is Web services, software that makes it easier to exchange information and conduct transactions. Wikis and blogs are being increasingly used in companies throughout the world. Satisfied users of these information technologies report that they are using these tools to interact with their customers, suppliers, and outside experts in product development efforts known as *co-creation*. For example, LEGO invited customers to suggest new models interactively and then financially rewarded the people whose ideas proved marketable.[83]

Supply Chain Management

The expansion of the marketing-oriented Internet into intranets and extranets is making significant contributions to organizational performance through supply chain management. **Supply chain management** is the forming of networks for sourcing raw materials, manufacturing products or creating services, storing and distributing the goods, and delivering them to customers and consumers.[84] Research indicates that supplier network resources have a significant impact on firm performance.[85] A survey of global executives revealed that their interest in supply chains was first to reduce costs, and then to improve customer service and get new products to market faster.[86] More than 85% of senior executives stated that improving their firm's supply-chain performance was a top priority. Companies, like Wal-Mart, Dell, and Toyota, who are known to be exemplars in supply-chain management, spend only 4% of their revenues on supply chain costs compared to 10% by the average firm.[87]

Industry leaders are integrating modern information systems into their corporate value chains to harmonize companywide efforts and to achieve competitive advantage. For example, Heineken beer distributors input actual depletion figures and replenishment orders to the Netherlands brewer through their linked Web pages. This interactive planning system generates time-phased orders based on actual usage rather than on projected demand. Distributors are then able to modify plans based on local conditions or changes in marketing. Heineken uses these modifications to adjust brewing and supply schedules. As a result of this system, lead times have been reduced from the traditional 10–12 weeks to 4–6 weeks. This time savings is especially useful in an industry competing on product freshness. In another example, Procter & Gamble participates in an information network to move the company's line of consumer products through Wal-Mart's many stores. *Radio-frequency identification (RFID)* tags containing product information is used to track goods through inventory and distribution channels. As part of the network with Wal-Mart, P&G knows by cash register and by store what products have passed through the system every hour of each day. The network is linked by satellite communications on a real-time basis. With actual point-of-sale information, products are replenished to meet current demand and minimize stockouts while maintaining exceptionally low inventories.[88]

5.5 The Strategic Audit: A Checklist for Organizational Analysis

One way of conducting an organizational analysis to ascertain a company's strengths and weakness is by using the Strategic Audit found in **Appendix 1.A** at the end of Chapter 1. The audit provides a checklist of questions by area of concern. For example, Part IV of the audit examines corporate structure, culture, and resources. It looks at organizational resources and capabilities in terms of the functional areas of marketing, finance, R&D, operations, human resources, and information systems, among others.

5.6 Synthesis of Internal Factors

After strategists have scanned the internal organizational environment and identified factors for their particular corporation, they may want to summarize their analysis of these factors using a form such as that given in **Table 5–2**. This **IFAS (Internal Factor Analysis Summary) Table** is one way to organize the internal factors into the generally accepted categories of strengths and weaknesses as well as to analyze how well a particular company's management is responding to these specific factors in light of the perceived importance of these factors to the company. Use the VRIO framework (**V**alue, **R**areness, **I**mitability, & **O**rganization) to assess the importance of each of the factors that might be considered strengths. Except for its internal orientation, this IFAS Table is built the same way as the EFAS Table described in **Chapter 4** (in **Table 4–5**). To use the IFAS Table, complete the following steps:

1. In **Column 1** (***Internal Factors***), list the eight to ten most important strengths and weaknesses facing the company.

TABLE 5–2 Internal Factor Analysis Summary (IFAS Table): Maytag as Example

Internal Factors	Weight	Rating	Weighted Score	Comments
1	2	3	4	5
Strengths				
■ Quality Maytag culture	.15	5.0	.75	Quality key to success
■ Experienced top management	.05	4.2	.21	Know appliances
■ Vertical integration	.10	3.9	.39	Dedicated factories
■ Employer relations	.05	3.0	.15	Good, but deteriorating
■ Hoover's international orientation	.15	2.8	.42	Hoover name in cleaners
Weaknesses				
■ Process-oriented R&D	.05	2.2	.11	Slow on new products
■ Distribution channels	.05	2.0	.10	Superstores replacing small dealers
■ Financial position	.15	2.0	.30	High debt load
■ Global positioning	.20	2.1	.42	Hoover weak outside the United Kingdom and Australia
■ Manufacturing facilities	.05	4.0	.20	Investing now
Total Scores	1.00		3.05	

NOTES:

1. List strengths and weaknesses (8–10) in Column 1.
2. Weight each factor from **1.0** (Most Important) to **0.0** (Not Important) in Column 2 based on that factor's probable impact on the company's strategic position. **The total weights must sum to 1.00**.
3. Rate each factor from **5.0** (Outstanding) to **1.0** (Poor) in Column 3 based on the company's response to that factor.
4. Multiply each factor's weight times its rating to obtain each factor's weighted score in Column 4.
5. Use Column 5 (comments) for rationale used for each factor.
6. Add the individual weighted scores to obtain the total weighted score for the company in Column 4. This tells how well the company is responding to the factors in its internal environment.

SOURCE: T.L. Wheelen & J.D. Hunger, "Internal Factor Analysis Summary (IFAS)" Copyright © 1987, 1988, 1989, 1990 and 2005 by T.L. Wheelen. Copyright © 1991, 2003, and 2005 by Wheelen and Hunger Associates. Reprinted by permission.

2. In **Column 2** (***Weight***), assign a weight to each factor from **1.0** (*Most Important*) to **0.0** (*Not Important*) based on that factor's probable impact on a particular company's current strategic position. The higher the weight, the more important is this factor to the current and future success of the company. **All weights must sum to 1.0 regardless of the number of factors.**
3. In **Column 3** (***Rating***), assign a rating to each factor from **5.0** (*Outstanding*) to **1.0** (*Poor*) based on management's specific response to that particular factor. Each rating is a judgment regarding how well the company's management is currently dealing with each specific internal factor.
4. In **Column 4** (***Weighted Score***), multiply the weight in **Column 2** for each factor times its rating in **Column 3** to obtain that factor's weighted score.
5. In **Column 5** (***Comments***), note why a particular factor was selected and/or how its weight and rating were estimated.
6. Finally, add the weighted scores for all the internal factors in **Column 4** to determine the total weighted score for that particular company. The **total weighted score** indicates how well a particular company is responding to current and expected factors in its internal environment. The score can be used to compare that firm to other firms in its industry. Check to ensure that the total weighted score truly reflects the company's current performance in terms of profitability and market share. **The total weighted score for an average firm in an industry is always 3.0.**

As an example of this procedure, **Table 5–2** includes a number of internal factors for Maytag Corporation in 1995 (before Maytag was acquired by Whirlpool) with corresponding weights, ratings, and weighted scores provided. Note that Maytag's total weighted score is 3.05, meaning that the corporation is about average compared to the strengths and weaknesses of others in the major home appliance industry.

End of Chapter SUMMARY

Every day, about 17 truckloads of used diesel engines and other parts are dumped at a receiving facility at Caterpillar's remanufacturing plant in Corinth, Mississippi. The filthy iron engines are then broken down by two workers, who manually hammer and drill for half a day until they have taken every bolt off the engine and put each component into its own bin. The engines are then cleaned and re-made at a half the cost of a new engine and sold for a tidy profit. This system works at Caterpillar because as a general rule, 70% of the cost to build something new is in the materials and 30% is in the labor. Remanufacturing simply starts the manufacturing process over again with materials that are essentially free and which already contain most of the energy costs needed to make them. The would-be discards become fodder for the next product, eliminating waste, and cutting costs. Caterpillar's management was so impressed by the remanufacturing operation that they made the business a separate division in 2005. The unit earned more than $1 billion in sales in 2005 and expects 15% growth for many more years—given the steadily increasing cost of oil and raw materials.

Caterpillar's remanufacturing unit was successful not only because of its capability of wringing productivity out of materials and labor, but also because it designed its products for re-use. Before they are built new, remanufactured products must be designed for disassembly. In order to achieve this, Caterpillar asks its designers to check a "Reman" box on Caterpillar's

product development checklist. The company also needs to know where its products are being used in order to take them back—known as the art of *reverse logistics*. This is achieved by Caterpillar's excellent relationship with its dealers throughout the world as well as through financial incentives. For example, when a customer orders a crankshaft, that customer is offered a remanufactured one for half the cost of a new one—assuming the customer turns in the old crankshaft to Caterpillar. The products also should be built for performance with little regard for changing fashion. Since diesel engines change little from year to year, a remanufactured engine is very similar to a new engine and might perform even better.

Monitoring the external environment is only one part of environmental scanning. Strategists also need to scan a corporation's internal environment to identify its resources, capabilities, and competencies. What are its strengths and weaknesses? At Caterpillar, management clearly noted that the environment was changing in a way to make its remanufactured product more desirable. It took advantage of its strengths in manufacturing and distribution to offer a recycling service for its current customers and a low-cost alternative product for those who could not afford a new Caterpillar engine. It also happened to be an environmentally friendly, sustainable business model. Caterpillar's management felt that remanufacturing thus provided them with a strategic advantage over competitors who don't remanufacture. This is an example of a company using its capabilities in key functional areas to expand its business by moving into a new profitable position on its value chain.[89]

ECO-BITS

- The average number of plastic bottles used each year in the U.S. per person: 200
- The average number of plastic bottles recycled each year in the U.S. per person: 40
- Revenue produced in 2007 by recycling and ancillary industries: $236 billion
- Share of electronic waste that is hauled overseas, stripped unsafely, and dumped: 80%[90]

DISCUSSION QUESTIONS

1. What is the relevance of the resource-based view of the firm to strategic management in a global environment?
2. How can value-chain analysis help identify a company's strengths and weaknesses?
3. In what ways can a corporation's structure and culture be internal strengths or weaknesses?
4. What are the pros and cons of management's using the experience curve to determine strategy?
5. How might a firm's management decide whether it should continue to invest in current known technology or in new, but untested technology? What factors might encourage or discourage such a shift?

STRATEGIC PRACTICE EXERCISES

Can you analyze a corporation using the Internet? Try the following exercise.

1. Form into teams of around three to five people. Select a well-known publicly owned company to research. Inform the instructor of your choice.
2. Assign each person a separate task. One task might be to find the latest financial statements. Another would be to learn as much as possible about its top management and board of directors. Another might be to identify its business model. Another might be to identify its key competitors.
3. Conduct research on the company *using the Internet only*.
4. Meet with your team members to discuss what you have found. What are the company's opportunities, threats, strengths, and weaknesses? Go back to the Internet for more information, if needed.
5. Prepare a 3- to-5 page typed report of the company. The report should include the following:
   a. Does the firm have any core competencies? Are any of these distinctive (better than the competition) competencies? Does the firm have any competitive

advantage? Provide a SWOT analysis using EFAS and IFAS Tables.

b. What is the likely future of this firm if it continues on its current path?

c. Would you buy stock in this company? Assume that your team has $25,000 to invest. Allocate the money among the four to five primary competitors in this industry. List the companies, the number of shares purchased of each, the cost of each share as of a given date, and the total cost for each purchase assuming a typical commission used by an Internet broker, such as E-Trade or Scottrade.

KEY TERMS

brand (p. 152)
business model (p. 142)
capabilities (p. 138)
capital budgeting (p. 153)
competency (p. 138)
conglomerate structure (p. 148)
continuum of sustainability (p. 141)
core competencies (p. 138)
corporate culture (p. 149)
corporate reputation (p. 152)
distinctive competencies (p. 138)
divisional structure (p. 147)
durability (p. 140)
economies of scale (p. 158)
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experience curve (p. 157)
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organizational structures (p. 147)
product life cycle (p. 152)
R&D intensity (p. 154)
R&D mix (p. 154)
replicability (p. 141)
resource (p. 138)
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strategic business units (SBUs) (p. 148)
supply chain management (p. 163)
tacit knowledge (p. 141)
technological competence (p. 154)
technological discontinuity (p. 155)
technology transfer (p. 154)
transferability (p. 140)
transparency (p. 140)
value chain (p. 143)
virtual teams (p. 159)
VRIO framework (p. 138)

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Ending Case for Part Two

BOEING BETS THE COMPANY

The Boeing Company, a well-known U.S.-based manufacturer of commercial and military aircraft, faced a dilemma in 2004. Long the leader of the global airframe manufacturing industry, Boeing had been slowly losing market share since the 1990s to the European-based Airbus Industrie—now incorporated as the European Aeronautic & Space Company (EADS). In December 2001, the EADS board of directors had committed the corporation to an objective it had never before achieved—taking from Boeing the leadership of the commercial aviation industry by building the largest commercial jet plane in the world, the Airbus 380. The A380 would carry 481 passengers in a normal multiple-class seating configuration compared to the 416 passengers carried by Boeing's 747—400 in a similar seating configuration. The A380 would not only fly 621 miles farther than the 747, but it would cost airlines 15%–20% less per passenger to operate. With orders for 50 A380 aircraft in hand, the EADS board announced that the new plane would be ready for delivery during 2006. The proposed A380 program decimated the sales of Boeing's jumbo jet. Since 2000, airlines had ordered only 10 Boeing 747s configured for passengers.

Boeing was clearly a company in difficulty in 2004. Distracted by the 1996 acquisitions of McDonnell Douglas and Rockwell Aerospace, Boeing's top management had spent the next few years strengthening the corporation's historically weak position in aerospace and defense and had allowed its traditional competency in commercial aviation to deteriorate. Boeing, once the manufacturing marvel of the world, was now spending 10%–20% more than EADS (Airbus) to build a plane. The prices it asked for its planes were thus also higher. As a result, Boeing's estimated market share of the commercial market slid from nearly 70% in 1996 to less than half that by the end of 2003. EADS claimed to have delivered 300 aircraft to Boeing's 285 and to have won 56% of the 396 orders placed by airlines in 2003—quite an improvement from 1994, when EADS controlled only one-fifth of the market! This was quite an accomplishment, given that the A380 was so large that the modifications needed to accommodate it at airports would cost $80 to $100 million.

Even though defense sales now accounted for more than half of the company's revenues, Boeing's CEO realized that he needed to quickly act to regain Boeing's leadership of the commercial part of the industry. In December 2003, the board approved the strategic decision to promote a new commercial airplane, the Boeing 787, for sale to airlines. The 787 was a midrange aircraft, not a jumbo jet such as the A380. The 787 would carry between 220 and 250 passengers but consume 20% less fuel and be 10% cheaper to operate than its competitor, EADS' current midrange plane, the smaller wide-body A330-200. It was to be made from a graphite/epoxy resin instead of aluminum. It was designed to fly faster, higher, farther, cleaner, more quietly, and more efficiently than any other medium-sized jet. This was the first time since approving the 777 jet in 1990 that the company had launched an all-new plane program. Development costs were estimated at $8 billion over five years. Depending on the results of these sales efforts, the board would decide sometime during 2004 to either begin or cancel the 787 construction program. If approved, the planes could be delivered in 2008—two years after the delivery of the A380.

The Boeing 787 decision was based on a completely different set of assumptions from those used by the EADS board to approve the A380. EADS top management believed that the commercial market wanted even larger jumbo jets to travel long international routes. Airports in Asia, the Middle East, and Europe were becoming heavily congested. In these locations, the "hub-and-spoke" method of creating major airline hubs was flourishing. Using larger planes was a way of dealing with that congestion by flying more passengers per plane out of these hubs. EADS management believed that over the next 20 years, airlines and freight carriers would need a minimum of 1,500 more aircraft at least as big as the B747. EADS management had concluded that the key to controlling the future commercial market was by using larger, more expensive planes. The A380 was a very large bet on that future scenario. The A380 program would cost EADS almost $13 million before the first plane was delivered.

In contrast, Boeing's management believed in a very different future scenario. Noting the success of Southwest and JetBlue, among other airlines in North America, it concluded that no more than 320 extra-large planes would be

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sold in the future as the airline industry moved away from hub-and-spoke networks toward more direct flights between smaller airports. The fragmentation of the airline industry, with its emphasis on competing through lower costs was the primary rationale for Boeing's fuel-efficient 787. A secondary reason was to deal with increasing passenger complaints about shrinking legroom and seat room on current planes flown by cost-conscious airlines. The 787 was designed with larger windows, seats, lavatories, and overhead bins. The plane was being designed in both short- and long-range versions. Boeing's management predicted a market for 2,000 to 3,000 such planes. Additional support for the midrange plane came from some industry analysts who predicted that the huge A380 would give new meaning to the term "cattle class." To reach necessary economies of scale, the A380 would likely devote a large portion of both of its decks to economy class, with passengers sitting three or four across, the same configuration as most of Boeing's 747s.

Boeing's strategy to regain industry leadership with its proposed 787 airplane meant that the company would have to increase its manufacturing efficiency in order to keep the price low. To significantly cut costs, management would be forced to implement a series of new programs:

- Outsource approximately 70% of manufacturing. Could it find suppliers who could consistently make the high-quality parts needed by Boeing?
- Reduce final assembly time to three days (compared to 20 for its 737 plane) by having suppliers build completed plane sections. Could this many suppliers meet Boeing's exacting deadlines?
- Use new, lightweight composite materials in place of aluminum to reduce inspection time. Would the plane be as dependable and as easy to maintain as Boeing's aluminum airplanes?
- Resolve poor relations with labor unions caused by downsizing and outsourcing. The machinists' union would have to be given a greater voice in specifying manufacturing procedures. Would Boeing's middle managers be willing to share power with an antagonistic union?

Which vision of the future was correct? The long-term fortunes of both Boeing and EADS depended on two contrasting strategic decisions, based on two very different assessments of the market. If EADS was correct, the market would continue to demand ever-larger airplanes. If Boeing was correct, the current wave of jumbo jets had crested, and a new wave of fuel-saving midrange jets would soon replace them. Which company's strategy had the best chance of succeeding?

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PART 3

Strategy Formulation

CHAPTER 6

strategy formulation: situation analysis and Business Strategy

Midamar Corporation is a family-owned company in Cedar Rapids, Iowa, that has carved out a growing niche for itself in the world food industry: supplying food prepared according to strict religious standards. The company specializes in *halal foods*, which are produced and processed according to Islamic law for sale to Muslims. Why did it focus on this one type of food? According to owner-founder Bill Aossey, "It's a big world, and you can only specialize in so many places." Although halal foods are not as widely known as kosher foods (processed according to Judaic law), their market is growing along with Islam, the world's fastest-growing religion. Midamar purchases halal-certified meat from Midwestern companies certified to conduct halal processing. Certification requires practicing Muslims schooled in halal processing to slaughter the livestock and to oversee meat and poultry processing.

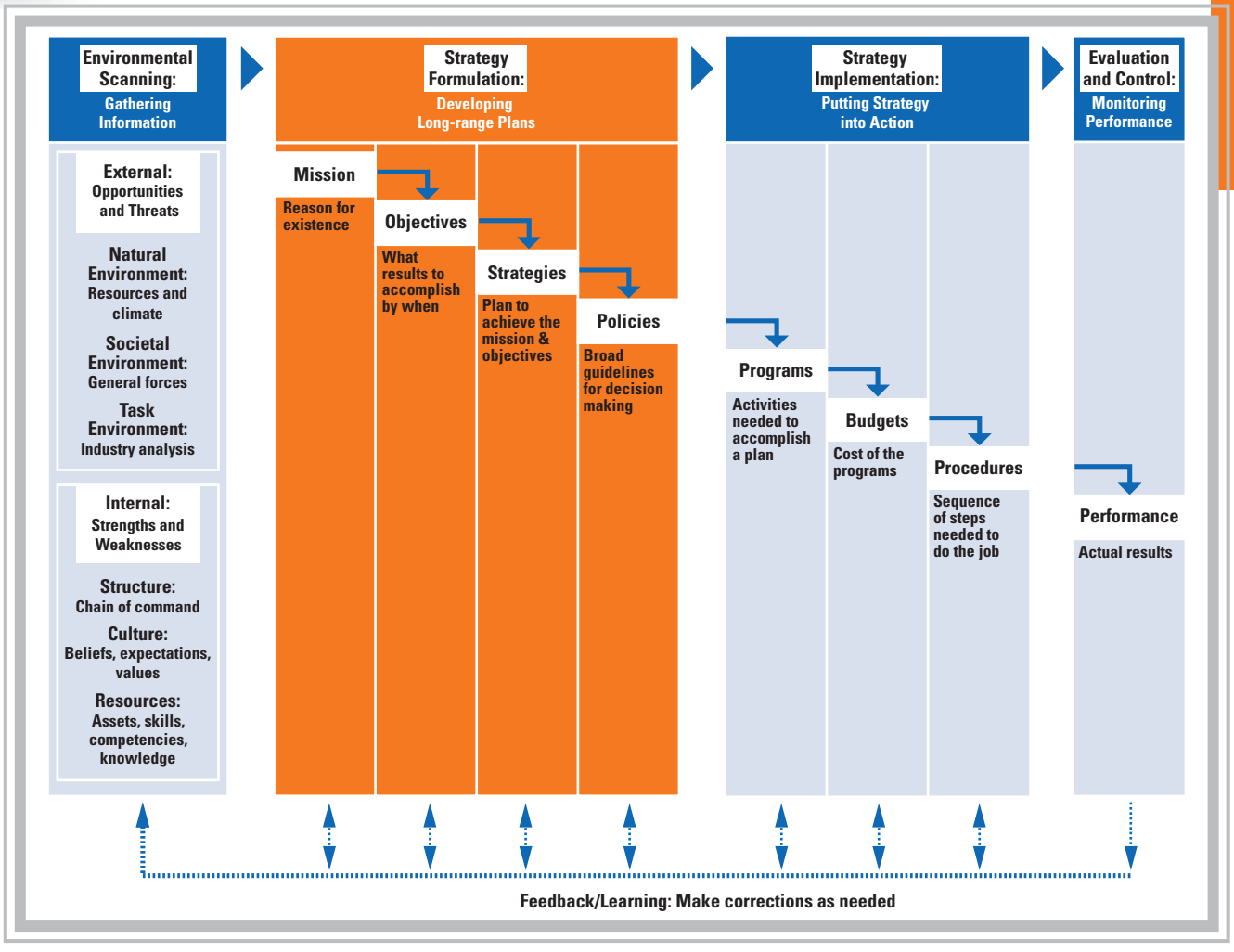
Aossey is a practicing Muslim who did not imagine such a vast market when he founded his business in 1974. "People thought it would be a passing fad," remarked Aossey. The company has grown to the point where it now exports halal-certified beef, lamb, and poultry to hotels, restaurants, and distributors in 30 countries throughout Asia, Africa, Europe, and North America. Its customers include McDonald's, Pizza Hut, and KFC. McDonald's, for example, uses Midamar's turkey strips as a bacon-alternative in a breakfast product in Singapore.[1]

Midamar is successful because its chief executive formulated a strategy designed to give it an advantage in a very competitive industry. It is an example of a differentiation focus competitive strategy in which a company focuses on a particular target market to provide a differentiated product or service. This strategy is one of the business competitive strategies discussed in this chapter.

Learning Objectives

After reading this chapter, you should be able to:

- Organize environmental and organizational information using SWOT analysis and a SFAS matrix
- Generate strategic options by using the TOWS matrix
- Understand the competitive and cooperative strategies available to corporations
- List the competitive tactics that would accompany competitive strategies
- Identify the basic types of strategic alliances



6.1 Situational Analysis: SWOT Analysis

Strategy formulation, often referred to as strategic planning or long-range planning, is concerned with developing a corporation's mission, objectives, strategies, and policies. It begins with situation analysis: the process of finding a strategic fit between external opportunities and internal strengths while working around external threats and internal weaknesses. As shown in the Strategic Decision-Making Process in Figure 1–5, step 5(a) is analyzing strategic factors in light of the current situation using SWOT analysis. **SWOT** is an acronym used to describe the particular **S**trengths, **W**eaknesses, **O**pportunities, and **T**hreats that are strategic factors for a specific company. SWOT analysis should not only result in the identification of a corporation's distinctive competencies—the particular capabilities and resources that a firm possesses and the superior way in which they are used—but also in the identification of opportunities that the firm is not currently able to take advantage of due to a lack of appropriate resources. Over the years, SWOT analysis has proven to be the most enduring analytical technique used in strategic management. For example, in a 2007 McKinsey & Company global survey of 2,700 executives, 82% of the executives stated that the most relevant activities for strategy formulation were evaluating the strengths and weaknesses of the organization and identifying top environmental trends affecting business unit performance over the next three to five years.[2] A 2005 survey of competitive intelligence professionals found that SWOT analysis was used by 82.7% of the respondents, the second most frequently used technique, trailing only competitor analysis.[3]

It can be said that the essence of strategy is opportunity divided by capacity.[4] An opportunity by itself has no real value unless a company has the capacity (i.e., resources) to take advantage of that opportunity. This approach, however, considers only opportunities and strengths when considering alternative strategies. By itself, a distinctive competency in a key resource or capability is no guarantee of competitive advantage. Weaknesses in other resource areas can prevent a strategy from being successful. SWOT can thus be used to take a broader view of strategy through the formula SA = O/(S – W) that is, (Strategic Alternative equals Opportunity divided by Strengths minus Weaknesses). This reflects an important issue strategic managers face: Should we invest more in our strengths to make them even stronger (a distinctive competence) or should we invest in our weaknesses to at least make them competitive?

SWOT analysis, by itself, is not a panacea. Some of the primary criticisms of SWOT analysis are:

- It generates lengthy lists.
- It uses no weights to reflect priorities.
- It uses ambiguous words and phrases.
- The same factor can be placed in two categories (e.g., a strength may also be a weakness).
- There is no obligation to verify opinions with data or analysis.
- It requires only a single level of analysis.
- There is no logical link to strategy implementation.[5]

GENERATING A STRATEGIC FACTORS ANALYSIS SUMMARY (SFAS) MATRIX

The EFAS and IFAS Tables plus the SFAS Matrix have been developed to deal with the criticisms of SWOT analysis. When used together, they are a powerful analytical set of tools for strategic analysis. The **SFAS (Strategic Factors Analysis Summary) Matrix** summarizes an organization's strategic factors by combining the external factors from the EFAS Table with

the internal factors from the IFAS Table. The EFAS and IFAS examples given of Maytag Corporation (as it was in 1995) in **Tables 4–5** and **5–2** list a total of 20 internal and external factors. These are too many factors for most people to use in strategy formulation. The SFAS Matrix requires a strategic decision maker to condense these strengths, weaknesses, opportunities, and threats into fewer than 10 strategic factors. This is done by reviewing and revising the weight given each factor. The revised weights reflect the priority of each factor as a determinant of the company's future success. The highest-weighted EFAS and IFAS factors should appear in the SFAS Matrix.

As shown in **Figure 6–1**, you can create an SFAS Matrix by following these steps:

1. In **Column 1** ***(Strategic Factors)***, list the most important EFAS and IFAS items. After each factor, indicate whether it is a Strength **(S)**, Weakness **(W)**, an Opportunity **(O)**, or a Threat **(T)**.
2. In **Column 2** ***(Weight)***, assign weights for all of the internal and external strategic factors. As with the EFAS and IFAS Tables presented earlier, the **weight column must total 1.00**. This means that the weights calculated earlier for EFAS and IFAS will probably have to be adjusted.
3. In **Column 3** ***(Rating)***, assign a rating of how the company's management is responding to each of the strategic factors. These ratings will probably (but not always) be the same as those listed in the EFAS and IFAS Tables.
4. In **Column 4** ***(Weighted Score)***, multiply the weight in **Column 2** for each factor by its rating in **Column 3** to obtain the factor's rated score.
5. In **Column 5** ***(Duration)***, depicted in **Figure 6–1**, indicate **short-term** (less than one year), **intermediate-term** (one to three years), or **long-term** (three years and beyond).
6. In **Column 6** ***(Comments)***, repeat or revise your comments for each strategic factor from the previous EFAS and IFAS Tables. **The total weighted score for the average firm in an industry is always 3.0.**

The resulting SFAS Matrix is a listing of the firm's external and internal strategic factors in one table. The example given in **Figure 6–1** is for Maytag Corporation in 1995, before the firm sold its European and Australian operations and it was acquired by Whirlpool. The SFAS Matrix includes only the most important factors gathered from environmental scanning and thus provides information that is essential for strategy formulation. The use of EFAS and IFAS Tables together with the SFAS Matrix deals with some of the criticisms of SWOT analysis. For example, the use of the SFAS Matrix reduces the list of factors to a manageable number, puts weights on each factor, and allows one factor to be listed as both a strength and a weakness (or as an opportunity and a threat).

FINDING A PROPITIOUS NICHE

One desired outcome of analyzing strategic factors is identifying a niche where an organization can use its core competencies to take advantage of a particular market opportunity. A niche is a need in the marketplace that is currently unsatisfied. The goal is to find a **propitious niche**—an extremely favorable niche—that is so well suited to the firm's internal and external environment that other corporations are not likely to challenge or dislodge it.[6] A niche is propitious to the extent that it currently is just large enough for one firm to satisfy its demand. After a firm has found and filled that niche, it is not worth a potential competitor's time or money to also go after the same niche. Such a niche may also be called a *strategic sweet spot*

FIGURE 6–1 Strategic Factor Analysis Summary (SFAS) Matrix

Internal Strategic Factors	Weight	Rating	Weighted Score	Comments
	1	2	3	4	5
Strengths				
S1 Quality Maytag culture	.15	5.0	.75	Quality key to success
S2 Experienced top management	.05	4.2	.21	Know appliances
S3 Vertical integration	.10	3.9	.39	Dedicated factories
S4 Employee relations	.05	3.0	.15	Good, but deteriorating
S5 Hoover's international orientation	.15	2.8	.42	Hoover name in cleaners
Weaknesses				
W1 Process-oriented R&D	.05	2.2	.11	Slow on new products
W2 Distribution channels	.05	2.0	.10	Superstores replacing small dealers
W3 Financial position	.15	2.0	.30	High debt load
W4 Global positioning	.20	2.1	.42	Hoover weak outside the United Kingdom and Australia
W5 Manufacturing facilities	.05	4.0	.20	Investing now
Total Scores	1.00		3.05	

External Strategic Factors	Weight	Rating	Weighted Score	Comments
	1	2	3	4	5
Opportunities				
O1 Economic integration of European Community	.20	4.1	.82	Acquisition of Hoover
O2 Demographics favor quality appliances	.10	5.0	.50	Maytag quality
O3 Economic development of Asia	.05	1.0	.05	Low Maytag presence
O4 Opening of Eastern Europe	.05	2.0	.10	Will take time
O5 Trend to "Super Stores"	.10	1.8	.18	Maytag weak in this channel
Threats				
T1 Increasing government regulations	.10	4.3	.43	Well positioned
T2 Strong U.S. competition	.10	4.0	.40	Well positioned
T3 Whirlpool and Electrolux strong globally	.15	3.0	.45	Hoover weak globally
T4 New product advances	.05	1.2	.06	Questionable
T5 Japanese appliance companies	.10	1.6	.16	Only Asian presence is Australia
Total Scores	1.00		3.15	

*The most important external and internal factors are identified in the EFAS and IFAS tables as shown here by shading these factors.

	1	2	3	4	Duration		5	6
	Strategic Factors (Select the most important opportunities/threats from EFAS, Table 4–5 and the most important strengths and weaknesses from IFAS, Table 5–2)	**Weight**	**Rating**	**Weighted Score**	**SHORT**	**INTERMEDIATE**	**LONG**	**Comments**
→	S1 Quality Maytag culture (S)	.10	5.0	.50			X	Quality key to success
→	S5 Hoover's international orientation (S)	.10	2.8	.28	X	X		Name recognition
→	W3 Financial position (W)	.10	2.0	.20	X	X		High debt
→	W4 Global positioning (W)	.15	2.2	.33		X	X	Only in N.A., U.K., and Australia
→	O1 Economic integration of European Community (O)	.10	4.1	.41			X	Acquisition of Hoover
→	O2 Demographics favor quality (O)	.10	5.0	.50		X		Maytag quality
→	O5 Trend to super stores (O + T)	.10	1.8	.18	X			Weak in this channel
→	T3 Whirlpool and Electrolux (T)	.15	3.0	.45	X			Dominate industry
→	T5 Japanese appliance companies (T)	.10	1.6	.16			X	Asian presence
	Total Scores	1.00		3.01				

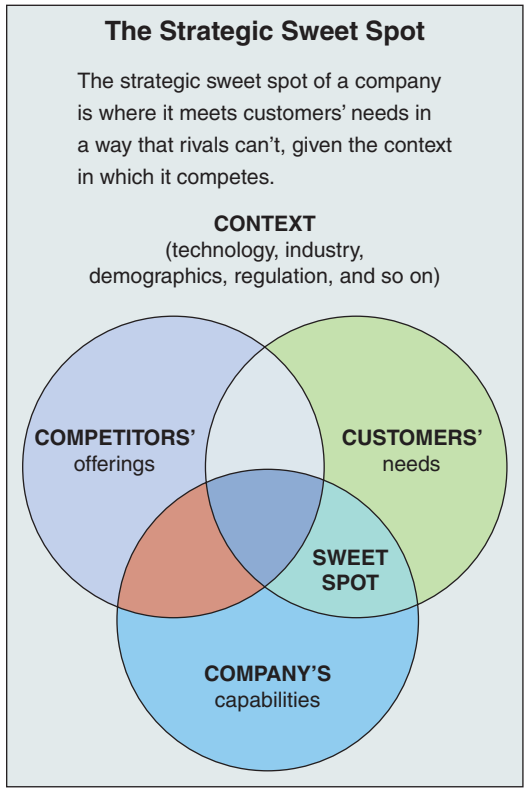
Notes:
1. List each of the most important factors developed in your IFAS and EFAS Tables in Column 1.
2. Weight each factor from 1.0 (Most Important) to 0.0 (Not Important) in Column 2 based on that factor's probable impact on the company's strategic position. **The total weights must sum to 1.00.**
3. Rate each factor from 5.0 (Outstanding) to 1.0 (Poor) in Column 3 based on the company's response to that factor.
4. Multiply each factor's weight times its rating to obtain each factor's weighted score in Column 4.
5. For duration in Column 5, check appropriate column (short term—less than 1 year; intermediate—1 to 3 years; long term—over 3 years).
6. Use Column 6 (comments) for rationale used for each factor.

SOURCE: T.L. Wheelen, J.D. Hunger, "Strategic Factor Analysis Summary (SFAS)." Copyright © 1987, 1988, 1989, 1990, 1991, 1992, 1993, 1994, 1995, 1996 and 2005 by T.L. Wheelen Copyright © 1997 and 2005 by Wheelen and Associates. Reprinted by permission.

(see **Figure 6–2**)—where a company is able to satisfy customers' needs in a way that rivals cannot, given the context in which it operates.[7]

Finding such a niche or sweet spot is not always easy. A firm's management must be always looking for a *strategic window*—that is, a unique market opportunity that is available only for a particular time. The first firm through a strategic window can occupy a propitious niche and discourage competition (if the firm has the required internal strengths). One company that successfully found a propitious niche was Frank J. Zamboni & Company, the manufacturer of the machines that smooth the ice at ice skating rinks. Frank Zamboni invented the

FIGURE 6–2
The Strategic Sweet Spot



SOURCE: D. J. Collis and M. G. Rukstad, "Can You Say What Your Strategy Is?" Reprinted by permission of Harvard Business Review. 'The Strategic Sweet Spot' from "Can You Say What Strategy is?" by D. J. Collis & M. G. Rukstad April 2008. Copyright © 2008 by the Harvard Business School Publishing Corporation. All rights reserved.

unique tractor-like machine in 1949 and no one has found a substitute for what it does. Before the machine was invented, people had to clean and scrape the ice by hand to prepare the surface for skating. Now hockey fans look forward to intermissions just to watch "the Zamboni" slowly drive up and down the ice rink, turning rough, scraped ice into a smooth mirror surface—almost like magic. So long as Zamboni's company was able to produce the machines in the quantity and quality desired, at a reasonable price, it was not worth another company's while to go after Frank Zamboni & Company's propitious niche.

As a niche grows, so can a company within that niche—by increasing its operations' capacity or through alliances with larger firms. The key is to identify a market opportunity in which the first firm to reach that market segment can obtain and keep dominant market share. For example, Church & Dwight was the first company in the United States to successfully market sodium bicarbonate for use in cooking. Its Arm & Hammer brand baking soda is still found in 95% of all U.S. households. The propitious niche concept is crucial to the software industry. Small initial demand in emerging markets allows new entrepreneurial ventures to go after niches too small to be noticed by established companies. When Microsoft developed its first disk operating system (DOS) in 1980 for IBM's personal computers, for example, the demand for such open systems software was very small—a small niche for a then very small Microsoft. The company was able to fill that niche and to successfully grow with it.

Niches can also change—sometimes faster than a firm can adapt to that change. A company's management may discover in their situation analysis that they need to invest heavily in the firm's capabilities to keep them competitively strong in a changing niche. South African

GLOBAL issue

SAB DEFENDS ITS PROPITIOUS NICHE

Out of 50 beers drunk by South Africans, 49 are brewed by South African Breweries (SAB). Founded more than a century ago, SAB controlled most of the local beer market by 1950 with brands such as Castle and Lion. When the government repealed the ban on the sale of alcohol to blacks in the 1960s, SAB and other brewers competed for the rapidly growing market. SAB fought successfully to retain its dominance of the market. With the end of apartheid, foreign brewers have been tempted to break SAB's near-monopoly but have been deterred by the entry barriers SAB has erected:

Entry Barrier #1: Every year for the past two decades SAB has reduced its prices. The "real" (adjusted for inflation) price of its beer is now half what it was during the 1970s. SAB has been able to achieve this through a continuous emphasis on productivity improvements—boosting production while cutting the workforce almost in half. Keeping prices low has been key to SAB's avoiding charges of abusing its monopoly.

Entry Barrier #2: In South Africa's poor and rural areas, roads are rough, and electricity is undependable. SAB has long experience in transporting crates to remote villages along bad roads and making sure that distributors have refrigerators (and electricity generators if needed). Many of its distributors are former employees who have been helped by the company to start their own trucking businesses.

Entry Barrier #3: Most of the beer sold in South Africa is sold through unlicensed pubs called *shebeens*—most of which date back to apartheid, when blacks were not allowed licenses. Although the current government of South Africa would be pleased to grant pub licenses to blacks, the shebeen owners don't want them. They enjoy not paying any taxes. SAB cannot sell directly to the shebeens, but it does so indirectly through wholesalers. The government, in turn, ignores the situation, preferring that people drink SAB beer than potentially deadly moonshine.

To break into South Africa, a new entrant would have to build large breweries and a substantial distribution network. SAB would, in turn, probably reduce its prices still further to defend its market. The difficulties of operating in South Africa are too great, the market is growing too slowly, and (given SAB's low cost position) the likely profit margin is too low to justify entering the market. Some foreign brewers, such as Heineken, would rather use SAB to distribute their products throughout South Africa. With its home market secure, SAB purchased Miller Brewing to secure a strong presence in North America.

SOURCE: Summarized from "Big Lion, Small Cage," *The Economist* (August 12, 2000), p. 56, and other sources.

Breweries (SAB), for example, took this approach when management realized that the only way to keep competitors out of its market was to continuously invest in increased productivity and infrastructure in order to keep its prices very low. See the **Global Issue** feature to see how SAB was able to successfully defend its market niche during significant changes in its environment.

6.2 Review of Mission and Objectives

A reexamination of an organization's current mission and objectives must be made before alternative strategies can be generated and evaluated. Even when formulating strategy, decision makers tend to concentrate on the alternatives—the action possibilities—rather than on a mission to be fulfilled and objectives to be achieved. This tendency is so attractive because it is much easier to deal with alternative courses of action that exist right here and now than to really think about what you want to accomplish in the future. The end result is that we often choose strategies that set our objectives for us rather than having our choices incorporate clear objectives and a mission statement.

Problems in performance can derive from an inappropriate statement of mission, which may be too narrow or too broad. If the mission does not provide a **common thread** (a unifying theme) for a corporation's businesses, managers may be unclear about where the company is heading. Objectives and strategies might be in conflict with each other. Divisions might be competing against one another rather than against outside competition—to the detriment of the corporation as a whole.

A company's objectives can also be inappropriately stated. They can either focus too much on short-term operational goals or be so general that they provide little real guidance. There may be a gap between planned and achieved objectives. When such a gap occurs, either the strategies have to be changed to improve performance or the objectives need to be adjusted downward to be more realistic. Consequently, objectives should be constantly reviewed to ensure their usefulness. This is what happened at Boeing when management decided to change its primary objective from being the largest in the industry to being the most profitable. This had a significant effect on its strategies and policies. Following its new objective, the company cancelled its policy of competing with Airbus on price and abandoned its commitment to maintaining a manufacturing capacity that could produce more than half a peak year's demand for airplanes.[8]

6.3 Generating Alternative Strategies by Using a TOWS Matrix

Thus far we have discussed how a firm uses SWOT analysis to assess its situation. SWOT can also be used to generate a number of possible alternative strategies. The **TOWS Matrix** (TOWS is just another way of saying SWOT) illustrates how the external opportunities and threats facing a particular corporation can be matched with that company's internal strengths and weaknesses to result in four sets of possible strategic alternatives. (See **Figure 6–3**.) This is a good way to use brainstorming to create alternative strategies that might not otherwise be considered. It forces strategic managers to create various kinds of growth as well as retrenchment strategies. It can be used to generate corporate as well as business strategies.

FIGURE 6–3
TOWS Matrix

INTERNAL FACTORS (IFAS) / EXTERNAL FACTORS (EFAS)	**Strengths (S)** List 5 – 10 *internal* strengths here	**Weaknesses (W)** List 5 – 10 *internal* weaknesses here
Opportunities (O) List 5 – 10 *external* opportunities here	**SO Strategies** Generate strategies here that use **strengths** to take **advantage** of **opportunities**	**WO Strategies** Generate strategies here that take **advantage** of **opportunities** by **overcoming weaknesses**
Threats (T) List 5 – 10 *external* threats here	**ST Strategies** Generate strategies here that use **strengths** to **avoid threats**	**WT Strategies** Generate strategies here that **minimize weaknesses** and **avoid threats**

SOURCE: *Reprinted from* Long-Range Planning, *Vol. 15, No. 2, 1982, Weihrich "The TOWS Matrix—A Tool For Situational Analysis," p. 60. Copyright © 1982 with permission of Elsevier.*

To generate a TOWS Matrix for Maytag Corporation in 1995, for example, use the External Factor Analysis Summary (EFAS) Table listed in **Table 4–5** from **Chapter 4** and the Internal Factor Analysis Summary (IFAS) Table listed in **Table 5–2** from **Chapter 5**. To build **Figure 6–4**, take the following steps:

1. In the **Opportunities (O)** block, list the external opportunities available in the company's or business unit's current and future environment from the EFAS Table (**Table 4–5**).
2. In the **Threats (T)** block, list the external threats facing the company or unit now and in the future from the EFAS Table (**Table 4–5**).
3. In the **Strengths (S)** block, list the specific areas of current and future strength for the company or unit from the IFAS Table (**Table 5–2**).
4. In the **Weaknesses (W)** block, list the specific areas of current and future weakness for the company or unit from the IFAS Table (**Table 5–2**).
5. Generate a series of possible strategies for the company or business unit under consideration based on particular combinations of the four sets of factors:
   - **SO Strategies** are generated by thinking of ways in which a company or business unit could use its strengths to take advantage of opportunities.
   - **ST Strategies** consider a company's or unit's strengths as a way to avoid threats.
   - **WO Strategies** attempt to take advantage of opportunities by overcoming weaknesses.
   - **WT Strategies** are basically defensive and primarily act to minimize weaknesses and avoid threats.

The TOWS Matrix is very useful for generating a series of alternatives that the decision makers of a company or business unit might not otherwise have considered. It can be used for the corporation as a whole (as is done in **Figure 6–4** with Maytag Corporation before it sold Hoover Europe), or it can be used for a specific business unit within a corporation (such as Hoover's floor care products). Nevertheless using a TOWS Matrix is only one of many ways to generate alternative strategies. Another approach is to evaluate each business unit within a corporation in terms of possible competitive and cooperative strategies.

6.4 Business Strategies

Business strategy focuses on improving the competitive position of a company's or business unit's products or services within the specific industry or market segment that the company or business unit serves. Business strategy is extremely important because research shows that business unit effects have double the impact on overall company performance than do either corporate or industry effects.[9] Business strategy can be competitive (battling against all competitors for advantage) and/or cooperative (working with one or more companies to gain advantage against other competitors). Just as corporate strategy asks what industry(ies) the company should be in, business strategy asks how the company or its units should compete or cooperate in each industry.

PORTER'S COMPETITIVE STRATEGIES

Competitive strategy raises the following questions:

- Should we compete on the basis of lower cost (and thus price), or should we differentiate our products or services on some basis other than cost, such as quality or service?

FIGURE 6–4 Generating a TOWS Matrix for Maytag Corporation

Internal Strategic Factors	Weight	Rating	Weighted Score	Comments
	1	2	3	4	5
Strengths				
S1 Quality Maytag culture	.15	5.0	.75	Quality key to success
S2 Experienced top management	.05	4.2	.21	Know appliances
S3 Vertical integration	.10	3.9	.39	Dedicated factories
S4 Employee relations	.05	3.0	.15	Good, but deteriorating
S5 Hoover's international orientation	.15	2.8	.42	Hoover name in cleaners
Weaknesses				
W1 Process-oriented R&D	.05	2.2	.11	Slow on new products
W2 Distribution channels	.05	2.0	.10	Superstores replacing small dealers
W3 Financial position	.15	2.0	.30	High debt load
W4 Global positioning	.20	2.1	.42	Hoover weak outside the United Kingdom and Australia
W5 Manufacturing facilities	.05	4.0	.20	Investing now
Total Scores	1.00		3.05	

External Strategic Factors	Weight	Rating	Weighted Score	Comments
	1	2	3	4	5
Opportunities				
O1 Economic integration of European Community	.20	4.1	.82	Acquisition of Hoover
O2 Demographics favor quality appliances	.10	5.0	.50	Maytag quality
O3 Economic development of Asia	.05	1.0	.05	Low Maytag presence
O4 Opening of Eastern Europe	.05	2.0	.10	Will take time
O5 Trend to "Super Stores"	.10	1.8	.18	Maytag weak in this channel
Threats				
T1 Increasing government regulations	.10	4.3	.43	Well positioned
T2 Strong U.S. competition	.10	4.0	.40	Well positioned
T3 Whirlpool and Electrolux strong globally	.15	3.0	.45	Hoover weak globally
T4 New product advances	.05	1.2	.06	Questionable
T5 Japanese appliance companies	.10	1.6	.16	Only Asian presence is Australia
Total Scores	1.00		3.15	

*The most important external and internal factors are identified in the EFAS and IFAS Tables as shown here by shading these factors.

Strengths →
Weaknesses →

Internal Factors (IFAS Table 5–2) / External Factors (EFAS Table 4–5)	Strengths (S)	Weaknesses (W)
	S1 Quality Maytag culture S2 Experienced top management S3 Vertical integration S4 Employee relations S5 Hoover's international orientation	W1 Process-oriented R&D W2 Distribution channels W3 Financial position W4 Global positioning W5 Manufacturing facilities
Opportunities (O) O1 Economic integration of European Community O2 Demographics favor quality O3 Economic development of Asia O4 Opening of Eastern Europe O5 Trend toward super stores	**SO Strategies** • *Use worldwide Hoover distribution channels to sell both Hoover and Maytag major appliances.* • *Find joint venture partners in Eastern Europe and Asia.*	**WO Strategies** • *Expand Hoover's presence in continental Europe by improving Hoover quality and reducing manufacturing and distribution costs.* • *Emphasize superstore channel for all non-Maytag brands.*
Threats (T) T1 Increasing government regulation T2 Strong U.S. competition T3 Whirlpool and Electrolux positioned for global economy T4 New product advances T5 Japanese appliance companies	**ST Strategies** • *Acquire Raytheon's appliance business to increase U.S. market share.* • *Merge with a Japanese major home appliance company.* • *Sell off all non-Maytag brands and strongly defend Maytag's U.S. niche.*	**WT Strategies** • *Sell off Dixie-Narco Division to reduce debt.* • *Emphasize cost reduction to reduce break-even point.* • *Sell out to Raytheon or a Japanese firm.*

Opportunities →
Threats →

- Should we compete head to head with our major competitors for the biggest but most sought-after share of the market, or should we focus on a niche in which we can satisfy a less sought-after but also profitable segment of the market?

Michael Porter proposes two "generic" competitive strategies for outperforming other corporations in a particular industry: lower cost and differentiation.[10] These strategies are called generic because they can be pursued by any type or size of business firm, even by not-for-profit organizations:

- **Lower cost strategy** is the ability of a company or a business unit to design, produce, and market a comparable product more efficiently than its competitors.
- **Differentiation strategy** is the ability of a company to provide unique and superior value to the buyer in terms of product quality, special features, or after-sale service.

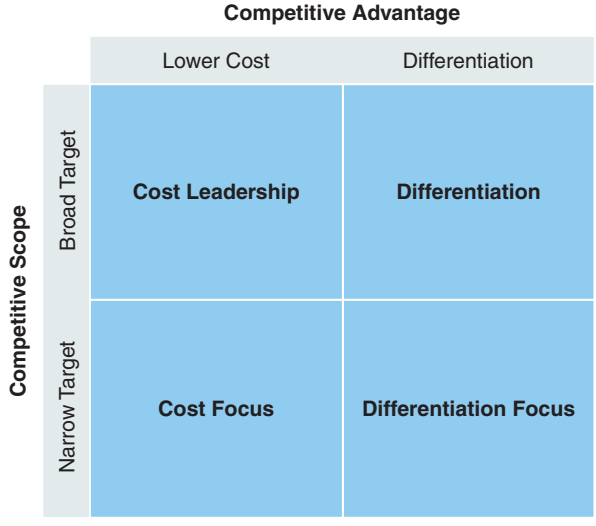
Porter further proposes that a firm's competitive advantage in an industry is determined by its **competitive scope**, that is, the breadth of the company's or business unit's target market. Before using one of the two generic competitive strategies (lower cost or differentiation), the firm or unit must choose the range of product varieties it will produce, the distribution channels it will employ, the types of buyers it will serve, the geographic areas in which it will sell, and the array of related industries in which it will also compete. This should reflect an understanding of the firm's unique resources. Simply put, a company or business unit can

choose a broad target (that is, aim at the middle of the mass market) or a narrow target (that is, aim at a market niche). Combining these two types of target markets with the two competitive strategies results in the four variations of generic strategies depicted in **Figure 6–5**. When the lower-cost and differentiation strategies have a broad mass-market target, they are simply called *cost leadership* and *differentiation*. When they are focused on a market niche (narrow target), however, they are called *cost focus* and *differentiation focus*. Although research does indicate that established firms pursuing broad-scope strategies outperform firms following narrow-scope strategies in terms of ROA (Return on Assets), new entrepreneurial firms have a better chance of surviving if they follow a narrow-scope rather than a broad-scope strategy.[11]

Cost leadership is a lower-cost competitive strategy that aims at the broad mass market and requires "aggressive construction of efficient-scale facilities, vigorous pursuit of cost reductions from experience, tight cost and overhead control, avoidance of marginal customer accounts, and cost minimization in areas like R&D, service, sales force, advertising, and so on."[12] Because of its lower costs, the cost leader is able to charge a lower price for its products than its competitors and still make a satisfactory profit. Although it may not necessarily have the lowest costs in the industry, it has lower costs than its competitors. Some companies successfully following this strategy are Wal-Mart (discount retailing), McDonald's (fast-food restaurants), Dell (computers), Alamo (rental cars), Aldi (grocery stores), Southwest Airlines, and Timex (watches). Having a lower-cost position also gives a company or business unit a defense against rivals. Its lower costs allow it to continue to earn profits during times of heavy competition. Its high market share means that it will have high bargaining power relative to its suppliers (because it buys in large quantities). Its low price will also serve as a barrier to entry because few new entrants will be able to match the leader's cost advantage. As a result, cost leaders are likely to earn above-average returns on investment.

Differentiation is aimed at the broad mass market and involves the creation of a product or service that is perceived throughout its industry as unique. The company or business unit may then charge a premium for its product. This specialty can be associated with design or brand image, technology, features, a dealer network, or customer service. Differentiation is a viable strat-

FIGURE 6–5
Porter's Generic Competitive Strategies



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egy for earning above-average returns in a specific business because the resulting brand loyalty lowers customers' sensitivity to price. Increased costs can usually be passed on to the buyers. Buyer loyalty also serves as an entry barrier; new firms must develop their own distinctive competence to differentiate their products in some way in order to compete successfully. Examples of companies that successfully use a differentiation strategy are Walt Disney Productions (entertainment), BMW (automobiles), Nike (athletic shoes), Apple Computer (computers and cell phones), and Pacar (trucks). Pacar Inc., for example, charges 10% more for its Kenworth and Peterbilt 10-wheel diesel trucks than does market-leader Chrysler's Freightliner because of its focus on product quality and a superior dealer experience.[13] Research does suggest that a differentiation strategy is more likely to generate higher profits than does a low-cost strategy because differentiation creates a better entry barrier. A low-cost strategy is more likely, however, to generate increases in market share.[14] For an example of a differentiation strategy based upon environmental sustainability, see the **Environmental Sustainability Issue** feature on Patagonia.

Cost focus is a low-cost competitive strategy that focuses on a particular buyer group or geographic market and attempts to serve only this niche, to the exclusion of others. In using cost focus, the company or business unit seeks a cost advantage in its target segment. A good example of this strategy is Potlach Corporation, a manufacturer of toilet tissue. Rather than

ENVIRONMENTAL sustainability issue

PATAGONIA USES SUSTAINABILITY AS DIFFERENTIATION COMPETITIVE STRATEGY

Patagonia is a highly respected designer and manufacturer of outdoor clothing, outdoor gear, footwear, and luggage. Founded by Yvon Chouinard, an avid surfer and outdoorsman, the company reflects his commitment to both quality clothing and sustainable business practices. Since its founding in 1973, Patagonia has grown at a healthy rate and retained an excellent reputation in a highly competitive industry. It uses a differentiation competitive strategy emphasizing quality, but defines quality in a way differently from most other companies.

> *Our definition of quality includes a mandate for building products and working with processes that cause the least harm to the environment. We evaluate raw materials, invest in innovative technologies, rigorously police our waste and use a portion (1%) of our sales to support groups working to make a real difference. We acknowledge that the wild world we love best is disappearing. That is why those of us who work here share a strong commitment to protecting undomesticated lands and waters. We believe in using business to inspire solutions to the environmental crisis.*

Patagonia's Web site includes not only the usual information about its products lines, but also an environmental section that examines the company's business practices. Its *Footprint Chronicles* is an interactive mini-site that allows the viewer to track the impact of 10 specific Patagonia products from design through delivery. For example, the down sweater page tells how the company uses high-quality goose down from humanely raised geese. The down is minimally processed and the shell is made of recycled polyester. One problem is that the company had to increase the weight of the shell fabric when it switched to recycled polyester. Another problem is that the zipper is treated with a water repellent that contains perfluorooctanoic acid (PFOA), which has been found to persist in the environment and is not recyclable. The Web page tells that the company is investigating alternatives to the use of PFOA in water repellents and looking for ways to recycle down garments. The page then asks for feedback and gives the viewer the opportunity to see what others are saying.

Chairman Chouinard is proud of his company's reputation as a "green" company, but also wants the firm to be economically sustainable as well. According to Chouinard, "I look at this company as an experiment to see if we can run it so it's here 100 years from now and always makes the best-quality stuff."

SOURCE: S. Hamm, "A Passion for the Plan," *Business Week* (August 21/28, 2006), pp. 92–93 and corporate Web site accessed September 17, 2008, www.patagonia.com.

compete directly against Procter & Gamble's Charmin, Potlach makes the house brands for Albertson's, Safeway, Jewel, and many other grocery store chains. It matches the quality of the well-known brands, but keeps costs low by eliminating advertising and promotion expenses. As a result, Spokane-based Potlach makes 92% of the private-label bathroom tissue and one-third of all bathroom tissue sold in Western U.S. grocery stores.[15]

Differentiation focus, like cost focus, concentrates on a particular buyer group, product line segment, or geographic market. This is the strategy successfully followed by Midamar Corporation (distributor of halal foods), Morgan Motor Car Company (a manufacturer of classic British sports cars), Nickelodeon (a cable channel for children), Orphagenix (pharmaceuticals), and local ethnic grocery stores. In using differentiation focus, a company or business unit seeks differentiation in a targeted market segment. This strategy is valued by those who believe that a company or a unit that focuses its efforts is better able to serve the special needs of a narrow strategic target more effectively than can its competition. For example, Orphagenix is a small biotech pharmaceutical company that avoids head-to-head competition with big companies like AstraZenica and Merck by developing "orphan" drugs to target diseases that affect fewer than 200,000 people—diseases such as sickle cell anemia and spinal muscular atrophy that big drug makers are overlooking.[16]

Risks in Competitive Strategies

No one competitive strategy is guaranteed to achieve success, and some companies that have successfully implemented one of Porter's competitive strategies have found that they could not sustain the strategy. As shown in **Table 6–1**, each of the generic strategies has risks. For example, a company following a differentiation strategy must ensure that the higher price it charges for its higher quality is not too far above the price of the competition; otherwise customers will not see the extra quality as worth the extra cost. This is what is meant in **Table 6.1** by the term *cost proximity*. For years, Deere & Company was the leader in farm machinery until low-cost competitors from India and other developing countries began making low-priced products. Deere responded by building high-tech flexible manufacturing plants using mass-customization to cut its manufacturing costs and using innovation to create differentiated products which, although higher-priced, reduced customers' labor and fuel expenses.[17]

TABLE 6–1 Risks of Generic Competitive Strategies

Risks of Cost Leadership	Risks of Differentiation	Risks of Focus
Cost leadership is not sustained: ■ Competitors imitate. ■ Technology changes. ■ Other bases for cost leadership erode.	Differentiation is not sustained: ■ Competitors imitate. ■ Bases for differentiation become less important to buyers.	The focus strategy is imitated. The target segment becomes structurally unattractive: ■ Structure erodes. ■ Demand disappears.
Proximity in differentiation is lost.	Cost proximity is lost.	Broadly targeted competitors overwhelm the segment: ■ The segment's differences from other segments narrow. ■ The advantages of a broad line increase.
Cost focusers achieve even lower cost in segments.	Differentiation focusers achieve even greater differentiation in segments.	New focusers subsegment the industry.

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Issues in Competitive Strategies

Porter argues that to be successful, a company or business unit must achieve one of the previously mentioned generic competitive strategies. Otherwise, the company or business unit is *stuck in the middle* of the competitive marketplace with no competitive advantage and is doomed to below-average performance. A classic example of a company that found itself stuck in the middle was K-Mart. The company spent a lot of money trying to imitate both Wal-Mart's low-cost strategy and Target's quality differentiation strategy—only to end up in bankruptcy with no clear competitive advantage. Although some studies do support Porter's argument that companies tend to sort themselves into either lower cost or differentiation strategies and that successful companies emphasize only one strategy,[18] other research suggests that some combination of the two competitive strategies may also be successful.[19]

The Toyota and Honda auto companies are often presented as examples of successful firms able to achieve both of these generic competitive strategies. Thanks to advances in technology, a company may be able to design quality into a product or service in such a way that it can achieve both high quality and high market share—thus lowering costs.[20] Although Porter agrees that it is possible for a company or a business unit to achieve low cost and differentiation simultaneously, he continues to argue that this state is often temporary.[21] Porter does admit, however, that many different kinds of potentially profitable competitive strategies exist. Although there is generally room for only one company to successfully pursue the mass-market cost leadership strategy (because it is so dependent on achieving dominant market share), there is room for an almost unlimited number of differentiation and focus strategies (depending on the range of possible desirable features and the number of identifiable market niches). Quality, alone, has eight different dimensions—each with the potential of providing a product with a competitive advantage (see **Table 6–2**).

Most entrepreneurial ventures follow focus strategies. The successful ones differentiate their product from those of other competitors in the areas of quality and service, and they focus the product on customer needs in a segment of the market, thereby achieving a dominant

TABLE 6–2

The Eight Dimensions of Quality

1. Performance	Primary operating characteristics, such as a washing machine's cleaning ability.
2. Features	"Bells and whistles," such as cruise control in a car, that supplement the basic functions.
3. Reliability	Probability that the product will continue functioning without any significant maintenance.
4. Conformance	Degree to which a product meets standards. When a customer buys a product out of the warehouse, it should perform identically to that viewed on the showroom floor.
5. Durability	Number of years of service a consumer can expect from a product before it significantly deteriorates. Differs from reliability in that a product can be durable but still need a lot of maintenance.
6. Serviceability	Product's ease of repair.
7. Aesthetics	How a product looks, feels, sounds, tastes, or smells.
8. Perceived Quality	Product's overall reputation. Especially important if there are no objective, easily used measures of quality.

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share of that part of the market. Adopting guerrilla warfare tactics, these companies go after opportunities in market niches too small to justify retaliation from the market leaders.

Industry Structure and Competitive Strategy

Although each of Porter's generic competitive strategies may be used in any industry, certain strategies are more likely to succeed than others in some instances. In a **fragmented industry**, for example, where many small- and medium-sized local companies compete for relatively small shares of the total market, focus strategies will likely predominate. Fragmented industries are typical for products in the early stages of their life cycles. If few economies are to be gained through size, no large firms will emerge and entry barriers will be low—allowing a stream of new entrants into the industry. Chinese restaurants, veterinary care, used-car sales, ethnic grocery stores, and funeral homes are examples. Even though P.F. Chang's and the Panda Restaurant Group have firmly established themselves as chains in the United States, local, family-owned restaurants still comprise 87% of Asian casual dining restaurants.[22]

If a company is able to overcome the limitations of a fragmented market, however, it can reap the benefits of a broadly targeted cost-leadership or differentiation strategy. Until Pizza Hut was able to use advertising to differentiate itself from local competitors, the pizza fast-food business was a fragmented industry composed primarily of locally owned pizza parlors, each with its own distinctive product and service offering. Subsequently Domino's used the cost-leader strategy to achieve U.S. national market share.

As an industry matures, fragmentation is overcome, and the industry tends to become a **consolidated industry** dominated by a few large companies. Although many industries start out being fragmented, battles for market share and creative attempts to overcome local or niche market boundaries often increase the market share of a few companies. After product standards become established for minimum quality and features, competition shifts to a greater emphasis on cost and service. Slower growth, overcapacity, and knowledgeable buyers combine to put a premium on a firm's ability to achieve cost leadership or differentiation along the dimensions most desired by the market. R&D shifts from product to process improvements. Overall product quality improves, and costs are reduced significantly.

The *strategic rollup* was developed in the mid-1990s as an efficient way to quickly consolidate a fragmented industry. With the aid of money from venture capitalists, an entrepreneur acquires hundreds of owner-operated small businesses. The resulting large firm creates economies of scale by building regional or national brands, applies best practices across all aspects of marketing and operations, and hires more sophisticated managers than the small businesses could previously afford. Rollups differ from conventional mergers and acquisitions in three ways: (1) they involve large numbers of firms, (2) the acquired firms are typically owner operated, and (3) the objective is not to gain incremental advantage, but to reinvent an entire industry.[23] Rollups are currently under way in the funeral industry led by Service Corporation International, Stewart Enterprises, and the Loewen Group; and in the veterinary care industries by VCA (Veterinary Centers of America) Antech Inc. Of the 22,000 pet hospitals in the U.S., VCA Antech had acquired 465 by July 2008 with plans to continue acquisitions for the foreseeable future.[24]

Once consolidated, an industry has become one in which cost leadership and differentiation tend to be combined to various degrees, even though one competitive strategy may be primarily emphasized. A firm can no longer gain and keep high market share simply through low price. The buyers are more sophisticated and demand a certain minimum level of quality for price paid. For example, low-cost office supplies retailer Staples introduced in 2007 a line of premium office supplies called "My Style, My Way" in order to halt sliding sales.[25] Even McDonald's, long the leader in low-cost fast-food restaurants, has been forced to add healthier and more upscale food items, such as Asian chicken salad, comfortable chairs, and Wi-Fi Internet access in order to keep its increasingly sophisticated customer base.[26] The same is true for firms emphasizing high quality. Either the quality must be high enough and valued by the

customer enough to justify the higher price or the price must be dropped (through lowering costs) to compete effectively with the lower priced products. Hewlett-Packard, for example, spent years restructuring its computer business in order to cut Dell's cost advantage from 20% to just 10%.[27] Consolidation is taking place worldwide in the automobile, airline, computer, and home appliance industries.

Hypercompetition and Competitive Advantage Sustainability

Some firms are able to sustain their competitive advantage for many years,[28] but most find that competitive advantage erodes over time. In his book *Hypercompetition*, D'Aveni proposes that it is becoming increasingly difficult to sustain a competitive advantage for very long. "Market stability is threatened by short product life cycles, short product design cycles, new technologies, frequent entry by unexpected outsiders, repositioning by incumbents, and tactical redefinitions of market boundaries as diverse industries merge."[29] Consequently, a company or business unit must constantly work to improve its competitive advantage. It is not enough to be just the lowest-cost competitor. Through continuous improvement programs, competitors are usually working to lower their costs as well. Firms must find new ways not only to reduce costs further but also to add value to the product or service being provided.

The same is true of a firm or unit that is following a differentiation strategy. Maytag Corporation, for example, was successful for many years by offering the most reliable brand in North American major home appliances. It was able to charge the highest prices for Maytag brand washing machines. When other competitors improved the quality of their products, however, it became increasingly difficult for customers to justify Maytag's significantly higher price. Consequently Maytag Corporation was forced not only to add new features to its products but also to reduce costs through improved manufacturing processes so that its prices were no longer out of line with those of the competition. D'Aveni's theory of hypercompetition is supported by developing research on the importance of building *dynamic capabilities* to better cope with uncertain environments (discussed previously in Chapter 5 in the resource-based view of the firm).

D'Aveni contends that when industries become hypercompetitive, they tend to go through escalating stages of competition. Firms initially compete on cost and quality, until an abundance of high-quality, low-priced goods result. This occurred in the U.S. major home appliance industry by 1980. In a second stage of competition, the competitors move into untapped markets. Others usually imitate these moves until the moves become too risky or expensive. This epitomized the major home appliance industry during the 1980s and 1990s, as strong U.S. and European firms like Whirlpool, Electrolux, and Bosch-Siemens established presences in both Europe and the Americas and then moved into Asia. Strong Asian firms like LG and Haier likewise entered Europe and the Americas in the late 1990s.

According to D'Aveni, firms then raise entry barriers to limit competitors. Economies of scale, distribution agreements, and strategic alliances made it all but impossible for a new firm to enter the major home appliance industry by the end of the 20th century. After the established players have entered and consolidated all new markets, the next stage is for the remaining firms to attack and destroy the strongholds of other firms. Maytag's inability to hold onto its North American stronghold led to its acquisition by Whirlpool in 2006. Eventually, according to D'Aveni, the remaining large global competitors work their way to a situation of perfect competition in which no one has any advantage and profits are minimal.

Before hypercompetition, strategic initiatives provided competitive advantage for many years, perhaps for decades. Except for a few stable industries, this is no longer the case. According to D'Aveni, as industries become hypercompetitive, there is no such thing as a sustainable competitive advantage. Successful strategic initiatives in this type of industry typically last only months to a few years. According to D'Aveni, the only way a firm in this kind of dynamic industry can sustain any competitive advantage is through a continuous series of multiple short-term initiatives aimed at replacing a firm's current successful products

with the next generation of products before the competitors can do so. Intel and Microsoft are taking this approach in the hypercompetitive computer industry.

Hypercompetition views competition, in effect, as a distinct series of ocean waves on what used to be a fairly calm stretch of water. As industry competition becomes more intense, the waves grow higher and require more dexterity to handle. Although a strategy is still needed to sail from point A to point B, more turbulent water means that a craft must continually adjust course to suit each new large wave. One danger of D'Aveni's concept of hypercompetition, however, is that it may lead to an overemphasis on short-term tactics (discussed in the next section) over long-term strategy. Too much of an orientation on the individual waves of hypercompetition could cause a company to focus too much on short-term temporary advantage and not enough on achieving its long-term objectives through building sustainable competitive advantage. Nevertheless, research supports D'Aveni's argument that sustained competitive advantage is increasingly a matter not of a single advantage maintained over time, but more a matter of sequencing advantages over time.[30]

Which Competitive Strategy Is Best?

Before selecting one of Porter's generic competitive strategies for a company or business unit, management should assess its feasibility in terms of company or business unit resources and capabilities. Porter lists some of the commonly required skills and resources, as well as organizational requirements, in **Table 6–3**.

Competitive Tactics

Studies of decision making report that half the decisions made in organizations fail because of poor tactics.[31] A **tactic** is a specific operating plan that details how a strategy is to be implemented in terms of when and where it is to be put into action. By their nature, tactics are narrower in scope and shorter in time horizon than are strategies. Tactics, therefore, may be viewed

TABLE 6–3 Requirements for Generic Competitive Strategies

Generic Strategy	Commonly Required Skills and Resources	Common Organizational Requirements
Overall Cost Leadership	■ Sustained capital investment and access to capital ■ Process engineering skills ■ Intense supervision of labor ■ Products designed for ease of manufacture ■ Low-cost distribution system	■ Tight cost control ■ Frequent, detailed control reports ■ Structured organization and responsibilities ■ Incentives based on meeting strict quantitative targets
Differentiation	■ Strong marketing abilities ■ Product engineering ■ Creative flair ■ Strong capability in basic research ■ Corporate reputation for quality or technological leadership ■ Long tradition in the industry or unique combination of skills drawn from other businesses ■ Strong cooperation from channels	■ Strong coordination among functions in R&D, product development, and marketing ■ Subjective measurement and incentives instead of quantitative measures ■ Amenities to attract highly skilled labor, scientists, or creative people
Focus	■ Combination of the above policies directed at the particular strategic target	■ Combination of the above policies directed at the particular strategic target

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(like policies) as a link between the formulation and implementation of strategy. Some of the tactics available to implement competitive strategies are timing tactics and market location tactics.

Timing Tactics: When to Compete

A **timing tactic** deals with *when* a company implements a strategy. The first company to manufacture and sell a new product or service is called the **first mover** (or pioneer). Some of the advantages of being a first mover are that the company is able to establish a reputation as an industry leader, move down the learning curve to assume the cost-leader position, and earn temporarily high profits from buyers who value the product or service very highly. A successful first mover can also set the standard for all subsequent products in the industry. A company that sets the standard "locks in" customers and is then able to offer further products based on that standard.[32] Microsoft was able to do this in software with its Windows operating system, and Netscape garnered over an 80% share of the Internet browser market by being first to commercialize the product successfully. Research does indicate that moving first or second into a new industry or foreign country results in greater market share and shareholder wealth than does moving later.[33] Being first provides a company profit advantages for about 10 years in consumer goods and about 12 years in industrial goods.[34] This is true, however, only if the first mover has sufficient resources to both exploit the new market and to defend its position against later arrivals with greater resources.[35] Gillette, for example, has been able to keep its leadership of the razor category (70% market share) by continuously introducing new products.[36]

Being a first mover does, however, have its disadvantages. These disadvantages can be, conversely, advantages enjoyed by late-mover firms. **Late movers** may be able to imitate the technological advances of others (and thus keep R&D costs low), keep risks down by waiting until a new technological standard or market is established, and take advantage of the first mover's natural inclination to ignore market segments.[37] Research indicates that successful late movers tend to be large firms with considerable resources and related experience.[38] Microsoft is one example. Once Netscape had established itself as the standard for Internet browsers in the 1990s, Microsoft used its huge resources to directly attack Netscape's position with its Internet Explorer. It did not want Netscape to also set the standard in the developing and highly lucrative intranet market inside corporations. By 2004, Microsoft's Internet Explorer dominated Web browsers, and Netscape was only a minor presence. Nevertheless, research suggests that the advantages and disadvantages of first and late movers may not always generalize across industries because of differences in entry barriers and the resources of the specific competitors.[39]

Market Location Tactics: Where to Compete

A **market location tactic** deals with *where* a company implements a strategy. A company or business unit can implement a competitive strategy either offensively or defensively. An *offensive tactic* usually takes place in an established competitor's market location. A *defensive tactic* usually takes place in the firm's own current market position as a defense against possible attack by a rival.[40]

Offensive Tactics. Some of the methods used to attack a competitor's position are:

- **Frontal assault:** The attacking firm goes head to head with its competitor. It matches the competitor in every category from price to promotion to distribution channel. To be successful, the attacker must have not only superior resources, but also the willingness to persevere. This is generally a very expensive tactic and may serve to awaken a sleeping giant, depressing profits for the whole industry. This is what Kimberly-Clark did when it introduced Huggies disposable diapers against P&G's market-leading Pampers. The resulting competitive battle between the two firms depressed Kimberly-Clark's profits.[41]

- **Flanking maneuver:** Rather than going straight for a competitor's position of strength with a frontal assault, a firm may attack a part of the market where the competitor is weak. Texas Instruments, for example, avoided competing directly with Intel by developing microprocessors for consumer electronics, cell phones, and medical devices instead of computers. Taken together, these other applications are worth more in terms of dollars and influence than are computers, where Intel dominates.[42]
- **Bypass attack:** Rather than directly attacking the established competitor frontally or on its flanks, a company or business unit may choose to change the rules of the game. This tactic attempts to cut the market out from under the established defender by offering a new type of product that makes the competitor's product unnecessary. For example, instead of competing directly against Microsoft's Pocket PC and Palm Pilot for the handheld computer market, Apple introduced the iPod as a personal digital music player. It was the most radical change to the way people listen to music since the Sony Walkman. By redefining the market, Apple successfully sidestepped both Intel and Microsoft, leaving them to play "catch-up."[43]
- **Encirclement:** Usually evolving out of a frontal assault or flanking maneuver, encirclement occurs as an attacking company or unit encircles the competitor's position in terms of products or markets or both. The encircler has greater product variety (e.g., a complete product line, ranging from low to high price) and/or serves more markets (e.g., it dominates every secondary market). For example, Steinway was a major manufacturer of pianos in the United States until Yamaha entered the market with a broader range of pianos, keyboards, and other musical instruments. Although Steinway still dominates concert halls, it has only a 2% share of the U.S. market.[44] Oracle is using this strategy in its battle against market leader SAP for enterprise resource planning (ERP) software by "surrounding" SAP with acquisitions.[45]
- **Guerrilla warfare:** Instead of a continual and extensive resource-expensive attack on a competitor, a firm or business unit may choose to "hit and run." Guerrilla warfare is characterized by the use of small, intermittent assaults on different market segments held by the competitor. In this way, a new entrant or small firm can make some gains without seriously threatening a large, established competitor and evoking some form of retaliation. To be successful, the firm or unit conducting guerrilla warfare must be patient enough to accept small gains and to avoid pushing the established competitor to the point that it must respond or else lose face. Microbreweries, which make beer for sale to local customers, use this tactic against major brewers such as Anheuser-Busch.

Defensive Tactics. According to Porter, defensive tactics aim to lower the probability of attack, divert attacks to less threatening avenues, or lessen the intensity of an attack. Instead of increasing competitive advantage per se, they make a company's or business unit's competitive advantage more sustainable by causing a challenger to conclude that an attack is unattractive. These tactics deliberately reduce short-term profitability to ensure long-term profitability:[46]

- **Raise structural barriers.** Entry barriers act to block a challenger's logical avenues of attack. Some of the most important, according to Porter, are to:
  1. Offer a full line of products in every profitable market segment to close off any entry points (for example, Coca Cola offers unprofitable noncarbonated beverages to keep competitors off store shelves);
  2. Block channel access by signing exclusive agreements with distributors;
  3. Raise buyer switching costs by offering low-cost training to users;
  4. Raise the cost of gaining trial users by keeping prices low on items new users are most likely to purchase;

5. Increase scale economies to reduce unit costs;
6. Foreclose alternative technologies through patenting or licensing;
7. Limit outside access to facilities and personnel;
8. Tie up suppliers by obtaining exclusive contracts or purchasing key locations;
9. Avoid suppliers that also serve competitors; and
10. Encourage the government to raise barriers, such as safety and pollution standards or favorable trade policies.

- **Increase expected retaliation:** This tactic is any action that increases the perceived threat of retaliation for an attack. For example, management may strongly defend any erosion of market share by drastically cutting prices or matching a challenger's promotion through a policy of accepting any price-reduction coupons for a competitor's product. This counterattack is especially important in markets that are very important to the defending company or business unit. For example, when Clorox Company challenged P&G in the detergent market with Clorox Super Detergent, P&G retaliated by test marketing its liquid bleach, Lemon Fresh Comet, in an attempt to scare Clorox into retreating from the detergent market. Research suggests that retaliating quickly is not as successful in slowing market share loss as a slower, but more concentrated and aggressive response.[47]
- **Lower the inducement for attack:** A third type of defensive tactic is to reduce a challenger's expectations of future profits in the industry. Like Southwest Airlines, a company can deliberately keep prices low and constantly invest in cost-reducing measures. With prices kept very low, there is little profit incentive for a new entrant.[48]

COOPERATIVE STRATEGIES

A company uses competitive strategies and tactics to gain competitive advantage within an industry by battling against other firms. These are not, however, the only business strategy options available to a company or business unit for competing successfully within an industry. A company can also use **cooperative strategies** to gain competitive advantage within an industry by working with other firms. The two general types of cooperative strategies are collusion and strategic alliances.

Collusion

Collusion is the active cooperation of firms within an industry to reduce output and raise prices in order to get around the normal economic law of supply and demand. Collusion may be explicit, in which case firms cooperate through direct communication and negotiation, or tacit, in which case firms cooperate indirectly through an informal system of signals. Explicit collusion is illegal in most countries and in a number of regional trade associations, such as the European Union. For example, Archer Daniels Midland (ADM), the large U.S. agricultural products firm, conspired with its competitors to limit the sales volume and raise the price of the food additive lysine. Executives from three Japanese and South Korean lysine manufacturers admitted meeting in hotels in major cities throughout the world to form a "lysine trade association." The three companies were fined more than $20 million by the U.S. federal government.[49] In another example, Denver-based Qwest signed agreements favoring competitors that agreed not to oppose Qwest's merger with U.S. West or its entry into the long-distance business in its 14-state region. In one agreement, Qwest agreed to pay McLeodUSA almost $30 million to settle a billing dispute in return for McLeod's withdrawing its objections to Qwest's purchase of U.S. West.[50]

Collusion can also be tacit, in which case there is no direct communication among competing firms. According to Barney, tacit collusion in an industry is most likely to be successful if (1) there are a small number of identifiable competitors, (2) costs are similar among

firms, (3) one firm tends to act as the price leader, (4) there is a common industry culture that accepts cooperation, (5) sales are characterized by a high frequency of small orders, (6) large inventories and order backlogs are normal ways of dealing with fluctuations in demand, and (7) there are high entry barriers to keep out new competitors.[51]

Even tacit collusion can, however, be illegal. For example, when General Electric wanted to ease price competition in the steam turbine industry, it widely advertised its prices and publicly committed not to sell below those prices. Customers were even told that if GE reduced turbine prices in the future, it would give customers a refund equal to the price reduction. GE's message was not lost on Westinghouse, the major competitor in steam turbines. Both prices and profit margins remained stable for the next 10 years in this industry. The U.S. Department of Justice then sued both firms for engaging in "conscious parallelism" (following each other's lead to reduce the level of competition) in order to reduce competition.

Strategic Alliances

A **strategic alliance** is a long-term cooperative arrangement between two or more independent firms or business units that engage in business activities for mutual economic gain.[52] Alliances between companies or business units have become a fact of life in modern business. In the U.S. software industry, for example, the percentage of publicly traded firms that engaged in alliances increased from 32% in 1990 to 95% in 2001. During the same time period, the average number of alliances grew from four to more than 30 per firm.[53] Each of the top 500 global business firms now averages 60 major alliances.[54] Some alliances are very short term, only lasting long enough for one partner to establish a beachhead in a new market. Over time, conflicts over objectives and control often develop among the partners. For these and other reasons, around half of all alliances (including international alliances) perform unsatisfactorily.[55] Others are more long lasting and may even be preludes to full mergers between companies.

Many alliances do increase profitability of the members and have a positive effect on firm value.[56] A study by Cooper & Lybrand found that firms involved in strategic alliances had 11% higher revenue and 20% higher growth rate than did companies not involved in alliances.[57] Forming and managing strategic alliances is a capability that is learned over time. Research reveals that the more experience a firm has with strategic alliances, the more likely that its alliances will be successful.[58] (There is some evidence, however, that too much partnering experience with the same partners generates diminishing returns over time and leads to reduced performance.)[59] Consequently, leading firms are making investments in building and developing their partnering capabilities.[60]

Companies or business units may form a strategic alliance for a number of reasons, including:

1. **To obtain or learn new capabilities:** For example, General Motors and Chrysler formed an alliance in 2004 to develop new fuel-saving hybrid engines for their automobiles.[61] Alliances are especially useful if the desired knowledge or capability is based on tacit knowledge or on new poorly-understood technology.[62] A study found that firms with strategic alliances had more modern manufacturing technologies than did firms without alliances.[63]
2. **To obtain access to specific markets:** Rather than buy a foreign company or build breweries of its own in other countries, Anheuser-Busch chose to license the right to brew and market Budweiser to other brewers, such as Labatt in Canada, Modelo in Mexico, and Kirin in Japan. As another example, U.S. defense contractors and aircraft manufacturers selling to foreign governments are typically required by these governments to spend a percentage of the contract/purchase value, either by purchasing parts or obtaining sub-contractors, in that

country. This is often achieved by forming value-chain alliances with foreign companies either as parts suppliers or as sub-contractors.[64] In a survey by the *Economist Intelligence Unit*, 59% of executives stated that their primary reason for engaging in alliances was the need for fast and low-cost expansion into new markets.[65]

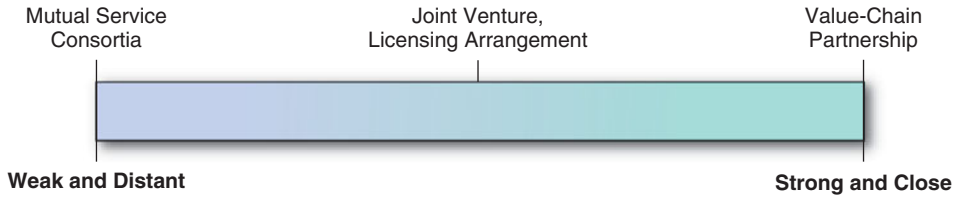
3. **To reduce financial risk:** Alliances take less financial resources than do acquisitions or going it alone and are easier to exit if necessary.[66] For example, because the costs of developing new large jet airplanes were becoming too high for any one manufacturer, Aerospatiale of France, British Aerospace, Construcciones Aeronáuticas of Spain, and Daimler-Benz Aerospace of Germany formed a joint consortium called Airbus Industrie to design and build such planes. Using alliances with suppliers is a popular means of outsourcing an expensive activity.
4. **To reduce political risk:** Forming alliances with local partners is a good way to overcome deficiencies in resources and capabilities when expanding into international markets.[67] To gain access to China while ensuring a positive relationship with the often restrictive Chinese government, Maytag Corporation formed a joint venture with the Chinese appliance maker, RSD.

Cooperative arrangements between companies and business units fall along a continuum from weak and distant to strong and close. (See **Figure 6–6**.) The types of alliances range from mutual service consortia to joint ventures and licensing arrangements to value-chain partnerships.[68]

Mutual Service Consortia. A **mutual service consortium** is a partnership of similar companies in similar industries that pool their resources to gain a benefit that is too expensive to develop alone, such as access to advanced technology. For example, IBM established a research alliance with Sony Electronics and Toshiba to build its next generation of computer chips. The result was the "cell" chip, a microprocessor running at 256 gigaflops—around ten times the performance of the fastest chips currently used in desktop computers. Referred to as a "supercomputer on a chip," cell chips were to be used by Sony in its PlayStation 3, by Toshiba in its high-definition televisions, and by IBM in its super computers.[69] The mutual service consortia is a fairly weak and distant alliance—appropriate for partners that wish to work together but not share their core competencies. There is very little interaction or communication among the partners.

Joint Venture. A **joint venture** is a "cooperative business activity, formed by two or more separate organizations for strategic purposes, that creates an independent business entity and allocates ownership, operational responsibilities, and financial risks and rewards to each member, while preserving their separate identity/autonomy."[70] Along with licensing arrangements, joint ventures lie at the midpoint of the continuum and are formed to pursue an

FIGURE 6–6
Continuum of Strategic Alliances



SOURCE: R.M. Kanter, 'Continuum of Strategic Alliances' from "Collaborative Advantage: The Art of Alliances," July-August 1994. Copyright © 1994 by the Harvard Business School Publishing Corporation. All rights reserved.

opportunity that needs a capability from two or more companies or business units, such as the technology of one and the distribution channels of another.

Joint ventures are the most popular form of strategic alliance. They often occur because the companies involved do not want to or cannot legally merge permanently. Joint ventures provide a way to temporarily combine the different strengths of partners to achieve an outcome of value to all. For example, Proctor & Gamble formed a joint venture with Clorox to produce food-storage wraps. P&G brought its cling-film technology and 20 full-time employees to the venture, while Clorox contributed its bags, containers, and wraps business.[71]

Extremely popular in international undertakings because of financial and political–legal constraints, forming joint ventures is a convenient way for corporations to work together without losing their independence. Around 30% to 55% of international joint ventures include three or more partners.[72] Disadvantages of joint ventures include loss of control, lower profits, probability of conflicts with partners, and the likely transfer of technological advantage to the partner. Joint ventures are often meant to be temporary, especially by some companies that may view them as a way to rectify a competitive weakness until they can achieve long-term dominance in the partnership. Partially for this reason, joint ventures have a high failure rate. Research indicates, however, that joint ventures tend to be more successful when both partners have equal ownership in the venture and are mutually dependent on each other for results.[73]

Licensing Arrangements. A **licensing arrangement** is an agreement in which the licensing firm grants rights to another firm in another country or market to produce and/or sell a product. The licensee pays compensation to the licensing firm in return for technical expertise. Licensing is an especially useful strategy if the trademark or brand name is well known but the MNC does not have sufficient funds to finance its entering the country directly. For example, Yum! Brands successfully used franchising and licensing to establish its KFC, Pizza Hut, Taco Bell, Long John Silvers, and A&W restaurants throughout the world. In 2007 alone, it opened 471 restaurants in China alone plus 852 more across six continents.[74] This strategy also becomes important if the country makes entry via investment either difficult or impossible. The danger always exists, however, that the licensee might develop its competence to the point that it becomes a competitor to the licensing firm. Therefore, a company should never license its distinctive competence, even for some short-run advantage.

Value-Chain Partnerships. A **value-chain partnership** is a strong and close alliance in which one company or unit forms a long-term arrangement with a key supplier or distributor for mutual advantage. For example, P&G, the maker of Folgers and Millstone coffee, worked with coffee appliance makers Mr. Coffee, Krups, and Hamilton Beach to use technology licensed from Black & Decker to market a pressurized, single-serve coffee-making system called Home Cafe. This was an attempt to reverse declining at-home coffee consumption at a time when coffeehouse sales were rising.[75]

To improve the quality of parts it purchases, companies in the U.S. auto industry, for example, have decided to work more closely with fewer suppliers and to involve them more in product design decisions. Activities that had previously been done internally by an automaker are being outsourced to suppliers specializing in those activities. The benefits of such relationships do not just accrue to the purchasing firm. Research suggests that suppliers that engage in long-term relationships are more profitable than suppliers with multiple short-term contracts.[76]

All forms of strategic alliances involve uncertainty. Many issues need to be dealt with when an alliance is initially formed, and others, which emerge later. Many problems revolve around the fact that a firm's alliance partners may also be its competitors, either immediately or in the future. According to Peter Lorange, an authority in strategy, one thorny issue in any strategic alliance is how to cooperate without giving away the company or business unit's core

TABLE 6–4

Strategic Alliance Success Factors

- Have a clear strategic purpose. Integrate the alliance with each partner's strategy. Ensure that mutual value is created for all partners.
- Find a fitting partner with compatible goals and complementary capabilities.
- Identify likely partnering risks and deal with them when the alliance is formed.
- Allocate tasks and responsibilities so that each partner can specialize in what it does best.
- Create incentives for cooperation to minimize differences in corporate culture or organization fit.
- Minimize conflicts among the partners by clarifying objectives and avoiding direct competition in the marketplace.
- In an international alliance, ensure that those managing it have comprehensive cross-cultural knowledge.
- Exchange human resources to maintain communication and trust. Don't allow individual egos to dominate.
- Operate with long-term time horizons. The expectation of future gains can minimize short-term conflicts.
- Develop multiple joint projects so that any failures are counterbalanced by successes.
- Agree on a monitoring process. Share information to build trust and keep projects on target. Monitor customer responses and service complaints.
- Be flexible in terms of willingness to renegotiate the relationship in terms of environmental changes and new opportunities.
- Agree on an exit strategy for when the partners' objectives are achieved or the alliance is judged a failure.

SOURCE: Compiled from B. Gomes-Casseres, "Do You Really Have an Alliance Strategy?" *Strategy & Leadership* (September/October 1998), pp. 6–11; L. Segil, "Strategic Alliances for the 21st Century," *Strategy & Leadership* (September/October 1998), pp. 12–16; and A. C. Inkpen and K-Q Li, "Joint Venture Formation: Planning and Knowledge Gathering for Success," *Organizational Dynamics* (Spring 1999), pp. 33–47. Inkpen and Li provide a checklist of 17 questions on p. 46.

competence: "Particularly when advanced technology is involved, it can be difficult for partners in an alliance to cooperate and openly share strategic know-how, but it is mandatory if the joint venture is to succeed."[77] It is therefore important that a company or business unit that is interested in joining or forming a strategic alliance consider the strategic alliance success factors listed in **Table 6–4**.

End of Chapter SUMMARY

Once environmental scanning is completed, situational analysis calls for the integration of this information. SWOT analysis is the most popular method for examining external and internal information. We recommend using the SFAS Matrix as one way to identify a corporation's strategic factors. Using the TOWS Matrix to identify a propitious niche is one way to develop a sustainable competitive advantage using those strategic factors.

Business strategy is composed of both competitive and cooperative strategy. As the external environment becomes more uncertain, an increasing number of corporations are choosing to simultaneously compete *and* cooperate with their competitors. These firms may cooperate to obtain efficiency in some areas, while each firm simultaneously tries to differentiate itself for competitive purposes. Raymond Noorda, Novell's founder and

former CEO, coined the term *co-opetition* to describe such simultaneous competition and cooperation among firms.[78] One example is the collaboration between competitors DHL and UPS in the express delivery market. DHL's American delivery business was losing money and UPS' costly airfreight network had excess capacity. Under the terms of a 10-year agreement signed in 2008, UPS carried DHL packages in its American airfreight network for a fee. The agreement covered only air freight, leaving both firms free to compete in the rest of the express-parcel business.[79] A careful balancing act, co-opetition involves the careful management of alliance partners so that each partner obtains sufficient benefits to keep the alliance together. A long-term view is crucial. An unintended transfer of knowledge could be enough to provide one partner a significant competitive advantage over the others.[80] Unless that company forebears from using that knowledge against its partners, the alliance will be doomed.

ECO-BITS

- Target became a certified organic produce retailer in 2006 and now offers more than 500 choices of organic certified food. The company reduces waste by giving away 7 million pounds of food annually.
- Home Depot offers more than 2,500 environmentally friendly products, ranging from all-natural insect repellants to front-loading washing machines, specially tagged as Eco Options.
- Vowing to become "carbon neutral" by 2010, Timberland introduced Green Index tags, which rate its products on the use of greenhouse gas emissions, solvents, and organic materials.[81]

DISCUSSION QUESTIONS

1. What industry forces might cause a propitious niche to disappear?
2. Is it possible for a company or business unit to follow a cost leadership strategy and a differentiation strategy simultaneously? Why or why not?
3. Is it possible for a company to have a sustainable competitive advantage when its industry becomes hypercompetitive?
4. What are the advantages and disadvantages of being a first mover in an industry? Give some examples of first mover and late mover firms. Were they successful?
5. Why are many strategic alliances temporary?

STRATEGIC PRACTICE EXERCISE

Select an industry to analyze. Identify companies for each of Porter's four competitive strategies. How many different kinds of differentiation strategies can you find?

INDUSTRY: _____

Cost Leadership: _____

Differentiation: _____

Cost Focus: _____

Differentiation Focus: _____

KEY TERMS

business strategy (p. 183)
collusion (p. 195)
common thread (p. 182)
competitive scope (p. 185)
competitive strategy (p. 183)
consolidated industry (p. 190)
cooperative strategy (p. 195)
cost focus (p. 187)
cost leadership (p. 186)
differentiation (p. 186)
differentiation focus (p. 188)
differentiation strategy (p. 185)
first mover (p. 193)
fragmented industry (p. 190)
joint venture (p. 197)
late mover (p. 193)
licensing arrangement (p. 198)
lower cost strategy (p. 185)
market location tactics (p. 193)
mutual service consortium (p. 197)
propitious niche (p. 177)
SFAS (Strategic Factors Analysis Summary) Matrix (p. 176)
strategic alliance (p. 196)
strategy formulation (p. 176)
SWOT (p. 176)
tactic (p. 192)
timing tactic (p. 193)
TOWS Matrix (p. 182)
value-chain partnership (p. 198)

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CHAPTER 7

strategy formulation: corporate Strategy

What is the best way for a company to grow if its primary business is maturing? A study of 1,850 companies by Zook and Allen revealed two conclusions: First, the most sustained profitable growth occurs when a corporation pushes out of the boundary around its core business into adjacent businesses. Second, corporations that consistently outgrow their rivals do so by developing a formula for expanding those boundaries in a predicable, repeatable manner.[1]

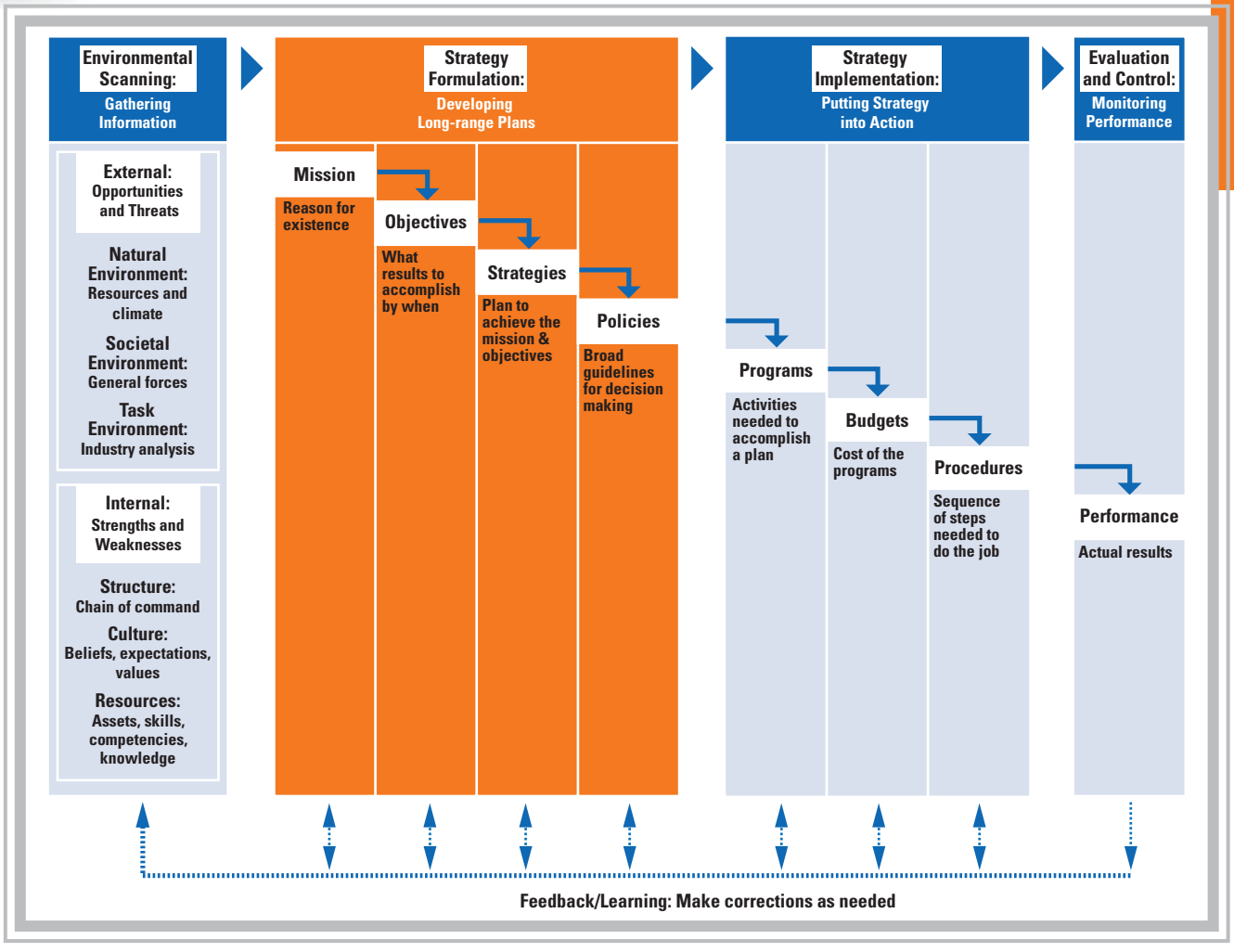
Nike is a classic example of this process. Despite its success in athletic shoes, no one expected Nike to be successful when it diversified in 1995 from shoes into golf apparel, balls, and equipment. Only a few years later, it was acknowledged to be a major player in the new business. According to researchers Zook and Allen, the key to Nike's success was a formula for growth that the company had applied and adapted successfully in a series of entries into sports markets, from jogging to volleyball to tennis to basketball to soccer and, most recently, to golf. First, Nike established a leading position in athletic shoes in the target market, in this case, golf shoes. Second, Nike launched a clothing line endorsed by the sports' top athletes—in this case, Tiger Woods. Third, the company formed new distribution channels and contracts with key suppliers in the new business. Nike's reputation as a strong marketer of new products gave it credibility. Fourth, the company introduced higher-margin equipment into the new market. In the case of golf clubs, it started with irons and then moved to drivers. Once it had captured a significant share in the U.S. market, Nike's next step was global distribution.

Zook and Allen propose that this formula was the reason Nike moved past Reebok in the sporting goods industry. In 1987, Nike's operating profits were only $164 million compared to Reebok's much larger $309 million. Fifteen years later, Nike's operating profits had grown to $1.1 billion while Reebok's had declined to $247 million.[2] Reebok was subsequently acquired by Adidas in 2005 while Nike went on to generate operating profits of $2.4 billion in 2008.

Learning Objectives

After reading this chapter, you should be able to:

- Understand the three aspects of corporate strategy
- Apply the directional strategies of growth, stability, and retrenchment
- Understand the differences between vertical and horizontal growth as well as concentric and conglomerate diversification
- Identify strategic options to enter a foreign country
- Apply portfolio analysis to guide decisions in companies with multiple products and businesses
- Develop a parenting strategy for a multiple-business corporation



7.1 Corporate Strategy

The vignette about Nike illustrates the importance of corporate strategy to a firm's survival and success. Corporate strategy deals with three key issues facing the corporation as a whole:

1. The firm's overall orientation toward growth, stability, or retrenchment (**directional strategy**)
2. The industries or markets in which the firm competes through its products and business units (**portfolio analysis**)
3. The manner in which management coordinates activities and transfers resources and cultivates capabilities among product lines and business units (**parenting strategy**)

Corporate strategy is primarily about the choice of direction for a firm as a whole and the management of its business or product portfolio.[3] This is true whether the firm is a small company or a large multinational corporation (MNC). In a large multiple-business company, in particular, corporate strategy is concerned with managing various product lines and business units for maximum value. In this instance, corporate headquarters must play the role of the organizational "parent," in that it must deal with various product and business unit "children." Even though each product line or business unit has its own competitive or cooperative strategy that it uses to obtain its own competitive advantage in the marketplace, the corporation must coordinate these different business strategies so that the corporation as a whole succeeds as a "family."[4]

Corporate strategy, therefore, includes decisions regarding the flow of financial and other resources to and from a company's product lines and business units. Through a series of coordinating devices, a company transfers skills and capabilities developed in one unit to other units that need such resources. In this way, it attempts to obtain synergy among numerous product lines and business units so that the corporate whole is greater than the sum of its individual business unit parts.[5] All corporations, from the smallest company offering one product in only one industry to the largest conglomerate operating in many industries with many products, must at one time or another consider one or more of these issues.

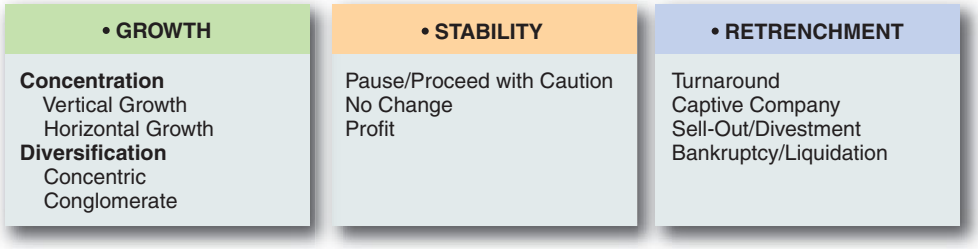
To deal with each of the key issues, this chapter is organized into three parts that examine corporate strategy in terms of *directional strategy* (orientation toward growth), *portfolio analysis* (coordination of cash flow among units), and *corporate parenting* (the building of corporate synergies through resource sharing and development).[6]

7.2 Directional Strategy

Just as every product or business unit must follow a business strategy to improve its competitive position, every corporation must decide its orientation toward growth by asking the following three questions:

1. Should we expand, cut back, or continue our operations unchanged?
2. Should we concentrate our activities within our current industry, or should we diversify into other industries?
3. If we want to grow and expand nationally and/or globally, should we do so through internal development or through external acquisitions, mergers, or strategic alliances?

FIGURE 7–1
Corporate Directional Strategies



A corporation's **directional strategy** is composed of three general orientations (sometimes called *grand strategies*):

- **Growth strategies** expand the company's activities.
- **Stability strategies** make no change to the company's current activities.
- **Retrenchment strategies** reduce the company's level of activities.

Having chosen the general orientation (such as growth), a company's managers can select from several more specific corporate strategies such as concentration within one product line/industry or diversification into other products/industries. (See **Figure 7–1**.) These strategies are useful both to corporations operating in only one industry with one product line and to those operating in many industries with many product lines.

GROWTH STRATEGIES

By far the most widely pursued corporate directional strategies are those designed to achieve growth in sales, assets, profits, or some combination. Companies that do business in expanding industries must grow to survive. Continuing growth means increasing sales and a chance to take advantage of the experience curve to reduce the per-unit cost of products sold, thereby increasing profits. This cost reduction becomes extremely important if a corporation's industry is growing quickly or consolidating and if competitors are engaging in price wars in attempts to increase their shares of the market. Firms that have not reached "critical mass" (that is, gained the necessary economy of large-scale production) face large losses unless they can find and fill a small, but profitable, niche where higher prices can be offset by special product or service features. That is why Oracle acquired PeopleSoft, a rival software firm, in 2005. Although still growing, the software industry was maturing around a handful of large firms. According to CEO Larry Ellison, Oracle needed to double or even triple in size by buying smaller and weaker rivals if it was to compete with SAP and Microsoft.[7] Growth is a popular strategy because larger businesses tend to survive longer than smaller companies due to the greater availability of financial resources, organizational routines, and external ties.[8]

A corporation can grow internally by expanding its operations both globally and domestically, or it can grow externally through mergers, acquisitions, and strategic alliances. A **merger** is a transaction involving two or more corporations in which stock is exchanged but in which only one corporation survives. Mergers usually occur between firms of somewhat similar size and are usually "friendly." The resulting firm is likely to have a name derived from its composite firms. One example is the merging of Allied Corporation and Signal Companies

to form Allied Signal. An **acquisition** is the purchase of a company that is completely absorbed as an operating subsidiary or division of the acquiring corporation. Procter & Gamble's (P&G's) purchase of Gillette is an example of a recent acquisition. Acquisitions usually occur between firms of different sizes and can be either friendly or hostile. Hostile acquisitions are often called *takeovers*.

Growth is a very attractive strategy for two key reasons:

- Growth based on increasing market demand may mask flaws in a company—flaws that would be immediately evident in a stable or declining market. A growing flow of revenue into a highly leveraged corporation can create a large amount of *organization slack* (unused resources) that can be used to quickly resolve problems and conflicts between departments and divisions. Growth also provides a big cushion for turnaround in case a strategic error is made. Larger firms also have more bargaining power than do small firms and are more likely to obtain support from key stakeholders in case of difficulty.
- A growing firm offers more opportunities for advancement, promotion, and interesting jobs. Growth itself is exciting and ego-enhancing for CEOs. The marketplace and potential investors tend to view a growing corporation as a "winner" or "on the move." Executive compensation tends to get bigger as an organization increases in size. Large firms are also more difficult to acquire than are smaller ones; thus an executive's job in a large firm is more secure.

The two basic growth strategies are **concentration** on the current product line(s) in one industry and **diversification** into other product lines in other industries.

Concentration

If a company's current product lines have real growth potential, concentration of resources on those product lines makes sense as a strategy for growth. The two basic concentration strategies are vertical growth and horizontal growth. Growing firms in a growing industry tend to choose these strategies before they try diversification.

Vertical Growth. **Vertical growth** can be achieved by taking over a function previously provided by a supplier or by a distributor. The company, in effect, grows by making its own supplies and/or by distributing its own products. This may be done in order to reduce costs, gain control over a scarce resource, guarantee quality of a key input, or obtain access to potential customers. This growth can be achieved either internally by expanding current operations or externally through acquisitions. Henry Ford, for example, used internal company resources to build his River Rouge plant outside Detroit. The manufacturing process was integrated to the point that iron ore entered one end of the long plant, and finished automobiles rolled out the other end, into a huge parking lot. In contrast, Cisco Systems, a maker of Internet hardware, chose the external route to vertical growth by purchasing Scientific-Atlanta Inc., a maker of set-top boxes for television programs and movies-on-demand. This acquisition gave Cisco access to technology for distributing television to living rooms through the Internet.[9]

Vertical growth results in **vertical integration**—the degree to which a firm operates vertically in multiple locations on an industry's value chain from extracting raw materials to manufacturing to retailing. More specifically, assuming a function previously provided by a supplier is called **backward integration** (going backward on an industry's value chain). The purchase of Carroll's Foods for its hog-growing facilities by Smithfield Foods, the world's largest pork processor, is an example of backward integration.[10] Assuming a function previously provided by a distributor is labeled **forward integration** (going forward on an industry's value chain). FedEx, for example, used forward integration when it purchased Kinko's in order to provide store-front package drop-off and delivery services for the small-business market.[11]

Vertical growth is a logical strategy for a corporation or business unit with a strong competitive position in a highly attractive industry—especially when technology is predictable and markets are growing.[12] To keep and even improve its competitive position, a company may use backward integration to minimize resource acquisition costs and inefficient operations as well as forward integration to gain more control over product distribution. The firm, in effect, builds on its distinctive competence by expanding along the industry's value chain to gain greater competitive advantage.

Although backward integration is often more profitable than forward integration (because of typical low margins in retailing), it can reduce a corporation's strategic flexibility. The resulting encumbrance of expensive assets that might be hard to sell could create an exit barrier, preventing the corporation from leaving that particular industry. Examples of single-use assets are blast furnaces and breweries. When demand drops in either of these industries (steel or beer), these assets have no alternative use, but continue to cost money in terms of debt payments, property taxes, and security expenses.

Transaction cost economics proposes that vertical integration is more efficient than contracting for goods and services in the marketplace when the transaction costs of buying goods on the open market become too great. When highly vertically integrated firms become excessively large and bureaucratic, however, the costs of managing the internal transactions may become greater than simply purchasing the needed goods externally—thus justifying outsourcing over vertical integration. This is why vertical integration and outsourcing are situation specific. Neither approach is best for all companies in all situations.[13] See the **Strategy Highlight 7.1** feature on how transaction cost economics helps explain why firms vertically integrate or outsource important activities. Research thus far provides mixed support for the predictions of transaction cost economics.[14]

Harrigan proposes that a company's degree of vertical integration can range from total ownership of the value chain needed to make and sell a product to no ownership at all.[15] (See **Figure 7–2**.) Under **full integration**, a firm internally makes 100% of its key supplies and completely controls its distributors. Large oil companies, such as British Petroleum and Royal Dutch Shell, are fully integrated. They own the oil rigs that pump the oil out of the ground, the ships and pipelines that transport the oil, the refineries that convert the oil to gasoline, and the trucks that deliver the gasoline to company-owned and franchised gas stations. Sherwin-Williams Company, which not only manufacturers paint, but also sells it in its own chain of 3,000 retail stores, is another example of a fully-integrated firm.[16] If a corporation does not want the disadvantages of full vertical integration, it may choose either taper or quasi-integration strategies.

With **taper integration** (also called concurrent sourcing), a firm internally produces less than half of its own requirements and buys the rest from outside suppliers (backward taper integration).[17] In the case of Smithfield Foods, its purchase of Carroll's allowed it to produce 27% of the hogs it needed to process into pork. In terms of forward taper integration, a firm sells part of its goods through company-owned stores and the rest through general wholesalers. Although Apple had 216 of its own retain stores in 2008, much of the company's sales continued to be through national chains such as Best Buy and through independent local and regional dealers.

With **quasi-integration**, a company does not make any of its key supplies but purchases most of its requirements from outside suppliers that are under its partial control (backward

FIGURE 7–2
Vertical Integration Continuum

SOURCE: *Suggested by K. R. Harrigan,* Strategies for Vertical Integration *(Lexington, Mass.: Lexington Books, D.C. Health, 1983), pp. 16–21.*

STRATEGY highlight 7.1

TRANSACTION COST ECONOMICS ANALYZES VERTICAL GROWTH STRATEGY

Why do corporations use vertical growth to permanently own suppliers or distributors when they could simply purchase individual items when needed on the open market? Transaction cost economics is a branch of institutional economics that attempts to answer this question. Transaction cost economics proposes that owning resources through vertical growth is more efficient than contracting for goods and services in the marketplace when the transaction costs of buying goods on the open market become too great. Transaction costs include the basic costs of drafting, negotiating, and safeguarding a market agreement (a contract) as well as the later managerial costs when the agreement is creating problems (goods aren't being delivered on time or quality is lower than needed), renegotiation costs (e.g., costs of meetings and phone calls), and the costs of settling disputes (e.g., lawyers' fees and court costs).

According to Williamson, three conditions must be met before a corporation will prefer internalizing a vertical transaction through ownership over contracting for the transaction in the marketplace: (1) a high level of uncertainty must surround the transaction, (2) assets involved in the transaction must be highly specialized to the transaction, and (3) the transaction must occur frequently. If there is a high level of uncertainty, it will be impossible to write a contract covering all contingencies, and it is likely that the contractor will act opportunistically to exploit any gaps in the written agreement—thus creating problems and increasing costs. If the assets being contracted for are highly specialized (e.g., goods or services with few alternate uses), there are likely to be few alternative suppliers—thus allowing the contractor to take advantage of the situation and increase costs. The more frequent the transactions, the more opportunity for the contractor to demand special treatment and thus increase costs further.

Vertical integration is not always more efficient than the marketplace, however. When highly vertically integrated firms become excessively large and bureaucratic, the costs of managing the internal transactions may become greater than simply purchasing the needed goods externally—thus justifying outsourcing over ownership. The usually hidden management costs (e.g., excessive layers of management, endless committee meetings needed for interdepartmental coordination, and delayed decision making due to excessively detailed rules and policies) add to the internal transaction costs—thus reducing the effectiveness and efficiency of vertical integration. The decision to own or to outsource is, therefore, based on the particular situation surrounding the transaction and the ability of the corporation to manage the transaction internally both effectively and efficiently.

SOURCES: O. E. Williamson and S. G. Winter, eds., *The Nature of the Firm: Origins, Evolution, and Development* (New York: Oxford University Press, 1991); E. Mosakowski, "Organizational Boundaries and Economic Performance: An Empirical Study of Entrepreneurial Computer Firms," *Strategic Management Journal* (February 1991), pp. 115–133; P. S. Ring and A. H. Van de Ven, "Structuring Cooperative Relationships Between Organizations," *Strategic Management Journal* (October 1992), pp. 483–498.

quasi-integration). A company may not want to purchase outright a supplier or distributor, but it still may want to guarantee access to needed supplies, new products, technologies, or distribution channels. For example, the pharmaceutical company Bristol-Myers Squibb purchased 17% of the common stock of ImClone in order to gain access to new drug products being developed through biotechnology. An example of forward quasi-integration would be a paper company acquiring part interest in an office products chain in order to guarantee that its products had access to the distribution channel. Purchasing part interest in another company usually provides a company with a seat on the other firm's board of directors, thus guaranteeing the acquiring firm both information and control. As in the case of Bristol-Myers Squibb and ImClone, a quasi-integrated firm may later decide to buy the rest of a key supplier that it did not already own.[18]

Long-term contracts are agreements between two firms to provide agreed-upon goods and services to each other for a specified period of time. This cannot really be considered to be vertical integration unless it is an *exclusive* contract that specifies that the supplier or distributor cannot have a similar relationship with a competitive firm. In that case, the supplier

or distributor is really a *captive company* that, although officially independent, does most of its business with the contracted firm and is formally tied to the other company through a long-term contract.

Recently there has been a movement away from vertical growth strategies (and thus vertical integration) toward cooperative contractual relationships with suppliers and even with competitors.[19] These relationships range from *outsourcing*, in which resources are purchased from outsiders through long-term contracts instead of being made in-house (for example, Hewlett-Packard bought its laser engines from Canon for HP's laser jet printers), to strategic alliances, in which partnerships, technology licensing agreements, and joint ventures supplement a firm's capabilities (for example, Toshiba has used strategic alliances with GE, Siemens, Motorola, and Ericsson to become one of the world's leading electronic companies).[20]

Horizontal Growth. A firm can achieve **horizontal growth** by expanding its operations into other geographic locations and/or by increasing the range of products and services offered to current markets. Research indicates that firms that grow horizontally by broadening their product lines have high survival rates.[21] Horizontal growth results in **horizontal integration**—the degree to which a firm operates in multiple geographic locations at the same point on an industry's value chain. For example, Procter & Gamble (P&G) continually adds additional sizes and multiple variations to its existing product lines to reduce possible niches competitors may enter. In addition, it introduces successful products from one part of the world to other regions. P&G has been introducing into China a steady stream of popular American brands, such as Head & Shoulders, Crest, Olay, Tide, Pampers, and Whisper. By 2007, it had 6,300 employees in China and the extensive distribution network it needed to prosper in the world's fastest growing market.[22]

Horizontal growth can be achieved through internal development or externally through acquisitions and strategic alliances with other firms in the same industry. For example, Delta Airlines acquired Northwest Airlines in 2008 to obtain access to Northwest's Asian markets and those American markets that Delta was not then serving. In contrast, many small commuter airlines engage in long-term contracts with major airlines in order to offer a complete arrangement for travelers. For example, the regional carrier Mesa Airlines arranged contractual agreements with United Airlines, U.S. Airways, and America West to be listed on their computer reservations, respectively, as United Express, U.S. Airways Express, and America West Express.

Horizontal growth is increasingly being achieved in today's world through international expansion. American's Wal-Mart, France's Carrefour, and Britain's Tesco are examples of national supermarket discount chains expanding horizontally throughout the world. This type of growth can be achieved internationally through many different strategies.

International Entry Options for Horizontal Growth

Research indicates that growing internationally is positively associated with firm profitability.[23] A corporation can select from several strategic options the most appropriate method for entering a foreign market or establishing manufacturing facilities in another country. The options vary from simple exporting to acquisitions to management contracts. See the **Global Issue** feature to see how U.S.-based firms are using international entry options in a horizontal growth strategy to expand throughout the world.

Some of the most popular options for international entry are as follows:

- **Exporting:** A good way to minimize risk and experiment with a specific product is **exporting**, shipping goods produced in the company's home country to other countries for marketing. The company could choose to handle all critical functions itself, or it could contract these functions to an export management company. Exporting is becoming increasingly

GLOBAL issue

COMPANIES LOOK TO INTERNATIONAL MARKETS FOR HORIZONTAL GROWTH

What do Wal-Mart, Starbucks, and International Paper have in common? For one thing, they are successful U.S. companies that grew to the point that eventually their products saturated the domestic market—resulting in slower growth in domestic sales and profits. For another, all are companies that have chosen the corporate growth strategy of concentrating in one industry. A third thing in common is that all of them are using international markets as a key growth opportunity.

From its humble beginnings in Bentonville, Arkansas, Wal-Mart has successfully grown such that its discount stores can now be found in most every corner of the nation. Knowing that Wal-Mart had fewer locations left in the United States on which to build stores, the company's management knew that the company's domestic growth could not be sustained past 2007. Consequently, the company began acquiring retail chains in other countries to eventually become the largest company in the world in terms of sales.

Growing from its base in Seattle, Washington, Starbucks expanded its coffee shops to every city in the country in only a few years. Soon imitators began opening their own versions until the U.S. market was completely saturated with coffee shops. Facing slow growth in its domestic market, Starbucks' management made the strategic decision to add fewer U.S. stores and to make international expansion its top priority.

Until recently, International Paper (IP) was international in name only. Founded in 1898, the company had once supplied 60% of the newsprint for American newspapers. After years of slow growth and weak financial performance, IP's management decided to divest unrelated businesses and to branch out from its North American roots to developing international markets. Acquisitions in Russia and green-field development in Brazil now positioned the company within low-cost, high-growth markets. IP's management hoped to soon control about half the office paper market in Latin America.

SOURCES: B. Helm and J. McGregor, "Howard Schultz's Grande Challenge," *Business Week* (January 21, 2008), p. 28; J. Bush, "Now It's Really International Paper," *Business Week* (December 17, 2007).

popular for small businesses because of the Internet, fax machines, toll-free numbers, and overnight express services, which reduce the once-formidable costs of going international.

- **Licensing:** Under a **licensing** agreement, the licensing firm grants rights to another firm in the host country to produce and/or sell a product. The licensee pays compensation to the licensing firm in return for technical expertise. This is an especially useful strategy if the trademark or brand name is well known, but the company does not have sufficient funds to finance its entering the country directly. Anheuser-Busch used this strategy to produce and market Budweiser beer in the United Kingdom, Japan, Israel, Australia, Korea, and the Philippines. This strategy is also important if the country makes entry via investment either difficult or impossible.
- **Franchising:** Under a **franchising** agreement, the franchiser grants rights to another company to open a retail store using the franchiser's name and operating system. In exchange, the franchisee pays the franchiser a percentage of its sales as a royalty. Franchising provides an opportunity for a firm to establish a presence in countries where the population or per capita spending is not sufficient for a major expansion effort.[24] Franchising accounts for 40% of total U.S. retail sales. Close to half of U.S. franchisers, such as Yum! Brands, franchise internationally.[25]
- **Joint Ventures:** Forming a **joint venture** between a foreign corporation and a domestic company is the most popular strategy used to enter a new country.[26] Companies often form joint ventures to combine the resources and expertise needed to develop new products or technologies. A joint venture may be an association between a company and a firm in the host country or a government agency in that country. A quick method of obtaining local

management, it also reduces the risks of expropriation and harassment by host country officials. A joint venture may also enable a firm to enter a country that restricts foreign ownership. The corporation can enter another country with fewer assets at stake and thus lower risk. Under Indian law, for example, foreign retailers are permitted to own no more than 51% of shops selling single-brand products, or to sell to others on a wholesale basis. These and other restrictions deterred supermarket giants Tesco and Carrefour from entering India. As a result, 97% of Indian retailing is composed of small, family-run stores. Eager to enter India, Wal-Mart's management formed an equal partnership joint venture in 2007 with Bharti Enterprises to start wholesale operations. Under the name Bharti-Mart, the new company planned to open a dozen small retail stores by 2015.[27]

- **Acquisitions:** A relatively quick way to move into an international area is through acquisitions—purchasing another company already operating in that area. Synergistic benefits can result if the company acquires a firm with strong complementary product lines and a good distribution network. For example, Belgium's InBev purchased Anheuser-Busch in 2008 for $52 billion to obtain a solid position in the profitable North American beer market. Before the acquisition, InBev had only a small presence in the U.S., but a strong one in Europe and Latin American, where Anheuser-Busch was weak.[28] Research suggests that wholly owned subsidiaries are more successful in international undertakings than are strategic alliances, such as joint ventures.[29] This is one reason why firms more experienced in international markets take a higher ownership position when making a foreign investment.[30] Cross-border acquisitions now account for 19% of all acquisitions in the United States—up from only 6% in 1985.[31] In some countries, however, acquisitions can be difficult to arrange because of a lack of available information about potential candidates. Government restrictions on ownership, such as the U.S. requirement that limits foreign ownership of U.S. airlines to 49% of nonvoting and 25% of voting stock, can also discourage acquisitions.
- **Green-Field Development:** If a company doesn't want to purchase another company's problems along with its assets, it may choose **green-field development** and build its own manufacturing plant and distribution system. Research indicates that firms possessing high levels of technology, multinational experience, and diverse product lines prefer green-field development to acquisitions.[32] This is usually a far more complicated and expensive operation than acquisition, but it allows a company more freedom in designing the plant, choosing suppliers, and hiring a workforce. For example, Nissan, Honda, and Toyota built auto factories in rural areas of Great Britain and then hired a young workforce with no experience in the industry. BMW did the same thing when it built its auto plant in Spartanburg, South Carolina, to make its Z3 and Z4 sports cars.
- **Production Sharing:** Coined by Peter Drucker, the term **production sharing** means the process of combining the higher labor skills and technology available in developed countries with the lower-cost labor available in developing countries. Often called *outsourcing*, one example is Maytag's moving some of its refrigeration production to a new plant in Reynosa, Mexico, in order to reduce labor costs. Many companies have moved data processing, programming, and customer service activities "offshore" to Ireland, India, Barbados, Jamaica, the Philippines, and Singapore, where wages are lower, English is spoken, and telecommunications are in place. As the number of technology services employees in India grew to be 15% of IBM's total tech services employees by 2007, the company has been able to eliminate 20,000 jobs in high-cost locations in the U.S., Europe, and Japan.[33]
- **Turnkey Operations: Turnkey operations** are typically contracts for the construction of operating facilities in exchange for a fee. The facilities are transferred to the host country or firm when they are complete. The customer is usually a government agency of, for example, a Middle Eastern country that has decreed that a particular product must be produced locally and under its control. For example, Fiat built an auto plant in Tagliatti,

Russia, for the Soviet Union in the late 1960s to produce an older model of Fiat under the brand name of Lada. MNCs that perform turnkey operations are frequently industrial equipment manufacturers that supply some of their own equipment for the project and that commonly sell replacement parts and maintenance services to the host country. They thereby create customers as well as future competitors. Interestingly, Renault purchased in 2008 a 25% stake in the same Tagliatti factory built by Fiat to help the Russian carmaker modernize, using Renault's low cost Logan as the base for the plant's new Lada model.[34]

- **BOT Concept:** The **BOT (Build, Operate, Transfer) concept** is a variation of the turnkey operation. Instead of turning the facility (usually a power plant or toll road) over to the host country when completed, the company operates the facility for a fixed period of time during which it earns back its investment plus a profit. It then turns the facility over to the government at little or no cost to the host country.[35]
- **Management Contracts:** A large corporation operating throughout the world is likely to have a large amount of management talent at its disposal. **Management contracts** offer a means through which a corporation can use some of its personnel to assist a firm in a host country for a specified fee and period of time. Management contracts are common when a host government expropriates part or all of a foreign-owned company's holdings in its country. The contracts allow the firm to continue to earn some income from its investment and keep the operations going until local management is trained.[36]

Diversification Strategies

According to strategist Richard Rumelt, companies begin thinking about diversification when their growth has plateaued and opportunities for growth in the original business have been depleted.[37] This often occurs when an industry consolidates, becomes mature, and most of the surviving firms have reached the limits of growth using vertical and horizontal growth strategies. Unless the competitors are able to expand internationally into less mature markets, they may have no choice but to diversify into different industries if they want to continue growing. The two basic diversification strategies are concentric and conglomerate.

Concentric (Related) Diversification. Growth through **concentric diversification** into a related industry may be a very appropriate corporate strategy when a firm has a strong competitive position but industry attractiveness is low.

Research indicates that the probability of succeeding by moving into a related business is a function of a company's position in its core business. For companies in leadership positions, the chances for success are nearly three times higher than those for followers.[38] By focusing on the characteristics that have given the company its distinctive competence, the company uses those very strengths as its means of diversification. The firm attempts to secure strategic fit in a new industry where the firm's product knowledge, its manufacturing capabilities, and the marketing skills it used so effectively in the original industry can be put to good use.[39] The corporation's products or processes are related in some way: they possess some common thread.

The search is for **synergy**, the concept that two businesses will generate more profits together than they could separately. The point of commonality may be similar technology, customer usage, distribution, managerial skills, or product similarity. This is the rationale taken by Quebec-based Bombardier, the world's third-largest aircraft manufacturer. In the 1980s, the company expanded beyond snowmobiles into making light rail equipment. Defining itself as a transportation company, it entered the aircraft business in 1986, with its purchase of Canadair, then best known for its fire-fighting airplanes. It later bought Learjet, a well-known maker of business jets. Over a 14-year period, Bombardier launched 14 new aircraft. In July 2008, the company announced its C Series Aircraft Program to manufacture a 110–130-seat "green" single-aisle family of airplanes to directly compete with Airbus and Boeing.[40]

A firm may choose to diversify concentrically through either internal or external means. Bombardier, for example, diversified externally through acquisitions. Toro, in contrast, grew internally in North America by using its current manufacturing processes and distributors to make and market snow blowers in addition to lawn mowers. When considering concentric diversification alternatives, see the criteria presented in **Strategy Highlight 7.2.**

Conglomerate (Unrelated) Diversification. When management realizes that the current industry is unattractive and that the firm lacks outstanding abilities or skills that it could easily transfer to related products or services in other industries, the most likely strategy is **conglomerate diversification**—diversifying into an industry unrelated to its current one. Rather than maintaining a common thread throughout their organization, strategic managers who adopt this strategy are primarily concerned with financial considerations of cash flow or risk reduction. This is also a good strategy for a firm that is able to transfer its own excellent management system into less-well-managed acquired firms. General Electric and Berkshire Hathaway are examples of companies that have used conglomerate diversification to grow successfully. Managed by Warren Buffet, Berkshire Hathaway has interests in furniture retailing, razor blades, airlines, paper, broadcasting, soft drinks, and publishing.[41]

The emphasis in conglomerate diversification is on sound investment and value-oriented management rather than on the product-market synergy common to concentric diversification. A cash-rich company with few opportunities for growth in its industry might, for example, move into another industry where opportunities are great but cash is hard to find. Another instance of conglomerate diversification might be when a company with a seasonal and,

STRATEGY highlight 7.2

SCREENING CRITERIA FOR CONCENTRIC DIVERSIFICATION

Market Attractiveness

1. Is the market large enough to be attractive?
2. Is the market growing faster than the economy?
3. Does it offer the potential to increase revenue from current customers?
4. Does it provide the ability to sell existing services to new customers?
5. Does it create a recurring revenue stream?
6. Are average earnings in the industry/market higher than in current businesses?
7. Is the market already taken by strong competitors?
8. Does it strengthen relationships with existing value-chain players?

Market Feasibility

1. Can the company enter the market within a year?
2. Are there any synergies in the geographic region where the market is located?
3. Can existing capabilities be leveraged for market entry?
4. Can existing assets be leveraged for market entry?
5. Can existing employees be used to support this opportunity?
6. Will current and future laws and regulations affect entry?
7. Is there a need for a strong brand in the new market?
8. If there is a need for partners, can the company secure and manage partner relationships?

SOURCE: Summarized from N. J. Kaplan, "Surviving and Thriving When Your Customers Contract," *Journal of Business Strategy* (January/February, 2003), p. 20.

therefore, uneven cash flow purchases a firm in an unrelated industry with complementing seasonal sales that will level out the cash flow. CSX management considered the purchase of a natural gas transmission business (Texas Gas Resources) by CSX Corporation (a railroad-dominated transportation company) to be a good fit because most of the gas transmission revenue was realized in the winter months—the lean period in the railroad business.

CONTROVERSIES IN DIRECTIONAL GROWTH STRATEGIES

Is vertical growth better than horizontal growth? Is concentration better than diversification? Is concentric diversification better than conglomerate diversification? Research reveals that companies following a related diversification strategy appear to be higher performers and survive longer than do companies with narrower scope following a pure concentration strategy.[42] Although the research is not in complete agreement, growth into areas related to a company's current product lines is generally more successful than is growth into completely unrelated areas.[43] For example, one study of various growth projects examined how many were considered successful, that is, still in existence after 22 years. The results were vertical growth, 80%; horizontal growth, 50%; concentric diversification, 35%; and conglomerate diversification, 28%.[44] This supports the conclusion from a study of 40 successful European companies that companies should first exploit their existing assets and capabilities before exploring for new ones, but that they should also diversify their portfolio of products.[45]

In terms of diversification strategies, research suggests that the relationship between relatedness and performance is curvilinear in the shape of an inverted U-shaped curve. If a new business is very similar to that of the acquiring firm, it adds little new to the corporation and only marginally improves performance. If the new business is completely different from the acquiring company's businesses, there may be very little potential for any synergy. If, however, the new business provides new resources and capabilities in a different, but similar, business, the likelihood of a significant performance improvement is high.[46]

Is internal growth better than external growth? Corporations can follow the growth strategies of either concentration or diversification through the internal development of new products and services, or through external acquisitions, mergers, and strategic alliances. The value of global acquisitions and mergers has steadily increased from less than $1 trillion in 1990 to $3.5 trillion in 2000.[47] According to a McKinsey & Company survey, managers are primarily motivated to purchase other companies in order to add capabilities, expand geographically, and buy growth.[48] Research generally concludes, however, that firms growing through acquisitions do not perform financially as well as firms that grow through internal means.[49] For example, on September 3, 2001, the day *before* HP announced that it was purchasing Compaq, HP's stock was selling at $23.11. After the announcement, the stock price fell to $18.87. Three years later, on September 21, 2004, the shares sold at $18.70.[50] One reason for this poor performance may be that acquiring firms tend to spend less on R&D than do other firms.[51] Another reason may be the typically high price of the acquisition itself. Studies reveal that over half to two-thirds of acquisitions are failures primarily because the premiums paid were too high for them to earn their cost of capital.[52] Another reason for the poor stock performance is that 50% of the customers of a merged firm are less satisfied with the combined company's service two years after the merger.[53] It is likely that neither strategy is best by itself and that some combination of internal and external growth strategies is better than using one or the other.[54]

What can improve acquisition performance? For one thing, the acquisition should be linked to strategic objectives and support corporate strategy. In addition, a corporation must be prepared to identify roughly 100 candidates and conduct due diligence investigation on around 40 companies in order to ultimately purchase 10 companies. This kind of effort requires

the capacity to sift through many candidates while simultaneously integrating previous acquisitions.[55] A study by Bain & Company of more than 11,000 acquisitions by companies throughout the world concluded that successful acquirers make small, low-risk acquisitions before moving on to larger ones.[56] Previous experience between an acquirer and a target firm in terms of R&D, manufacturing, or marketing alliances improves the likelihood of a successful acquisition.[57] Realizing that an acquired company must be carefully assimilated into the acquiring firm's operations, Cisco uses three criteria to judge whether a company is a suitable candidate for takeover:

- It must be relatively small.
- It must be comparable in organizational culture.
- It must be physically close to one of the existing affiliates.[58]

STABILITY STRATEGIES

A corporation may choose stability over growth by continuing its current activities without any significant change in direction. Although sometimes viewed as a lack of strategy, the stability family of corporate strategies can be appropriate for a successful corporation operating in a reasonably predictable environment.[59] They are very popular with small business owners who have found a niche and are happy with their success and the manageable size of their firms. Stability strategies can be very useful in the short run, but they can be dangerous if followed for too long. Some of the more popular of these strategies are the pause/proceed-with-caution, no-change, and profit strategies.

Pause/Proceed with Caution Strategy

A **pause/proceed-with-caution strategy** is, in effect, a timeout—an opportunity to rest before continuing a growth or retrenchment strategy. It is a very deliberate attempt to make only incremental improvements until a particular environmental situation changes. It is typically conceived as a temporary strategy to be used until the environment becomes more hospitable or to enable a company to consolidate its resources after prolonged rapid growth. This was the strategy Dell followed after its growth strategy had resulted in more growth than it could handle. Explained CEO Michael Dell, "We grew 285% in two years, and we're having some growing pains." Selling personal computers by mail enabled Dell to underprice competitors, but it could not keep up with the needs of a $2 billion, 5,600-employee company selling PCs in 95 countries. Dell did not give up on its growth strategy; it merely put it temporarily in limbo until the company was able to hire new managers, improve the structure, and build new facilities.[60] This was a popular strategy in late-2008 during a U.S. financial crisis when banks were freezing their lending and awaiting a rescue package from the federal government.

No-Change Strategy

A **no-change strategy** is a decision to do nothing new—a choice to continue current operations and policies for the foreseeable future. Rarely articulated as a definite strategy, a no-change strategy's success depends on a lack of significant change in a corporation's situation. The relative stability created by the firm's modest competitive position in an industry facing little or no growth encourages the company to continue on its current course, making only small adjustments for inflation in its sales and profit objectives. There are no obvious opportunities or threats, nor is there much in the way of significant strengths or weaknesses. Few aggressive new competitors are likely to enter such an industry. The corporation has probably

found a reasonably profitable and stable niche for its products. Unless the industry is undergoing consolidation, the relative comfort a company in this situation experiences is likely to encourage the company to follow a no-change strategy in which the future is expected to continue as an extension of the present. Many small-town businesses followed this strategy before Wal-Mart moved into their areas and forced them to rethink their strategy.

Profit Strategy

A **profit strategy** is a decision to do nothing new in a worsening situation but instead to act as though the company's problems are only temporary. The profit strategy is an attempt to artificially support profits when a company's sales are declining by reducing investment and short-term discretionary expenditures. Rather than announce the company's poor position to shareholders and the investment community at large, top management may be tempted to follow this very seductive strategy. Blaming the company's problems on a hostile environment (such as anti-business government policies, unethical competitors, finicky customers, and/or greedy lenders), management defers investments and/or cuts expenses (such as R&D, maintenance, and advertising) to stabilize profits during this period. It may even sell one of its product lines for the cash-flow benefits.

The profit strategy is useful only to help a company get through a temporary difficulty. It may also be a way to boost the value of a company in preparation for going public via an initial public offering (IPO). Unfortunately, the strategy is seductive and if continued long enough it will lead to a serious deterioration in a corporation's competitive position. The profit strategy is typically top management's passive, short-term, and often self-serving response to a difficult situation. In such situations, it is often better to face the problem directly by choosing a retrenchment strategy.

RETRENCHMENT STRATEGIES

A company may pursue retrenchment strategies when it has a weak competitive position in some or all of its product lines resulting in poor performance—sales are down and profits are becoming losses. These strategies impose a great deal of pressure to improve performance. In an attempt to eliminate the weaknesses that are dragging the company down, management may follow one of several retrenchment strategies, ranging from turnaround or becoming a captive company to selling out, bankruptcy, or liquidation.

Turnaround Strategy

Turnaround strategy emphasizes the improvement of operational efficiency and is probably most appropriate when a corporation's problems are pervasive but not yet critical. Research shows that poorly performing firms in mature industries have been able to improve their performance by cutting costs and expenses and by selling off assets.[61] Analogous to a weight-reduction diet, the two basic phases of a turnaround strategy are contraction and consolidation.[62]

Contraction is the initial effort to quickly "stop the bleeding" with a general, across-the-board cutback in size and costs. For example, when Howard Stringer was selected to be CEO of Sony Corporation in 2005, he immediately implemented the first stage of a turnaround plan by eliminating 10,000 jobs, closing 11 of 65 plants, and divesting many unprofitable electronics businesses. [63] The second phase, *consolidation*, implements a program to stabilize the now-leaner corporation. To streamline the company, plans are developed to reduce unnecessary overhead and to make functional activities cost-justified. This is a crucial time for the organization. If the consolidation phase is not conducted in a positive manner, many of the best people leave the organization. An overemphasis on downsizing and cutting costs coupled with a heavy

hand by top management is usually counterproductive and can actually hurt performance.[64] If, however, all employees are encouraged to get involved in productivity improvements, the firm is likely to emerge from this retrenchment period a much stronger and better-organized company. It has improved its competitive position and is able once again to expand the business.[65]

Captive Company Strategy

A **captive company strategy** involves giving up independence in exchange for security. A company with a weak competitive position may not be able to engage in a full-blown turnaround strategy. The industry may not be sufficiently attractive to justify such an effort from either the current management or investors. Nevertheless, a company in this situation faces poor sales and increasing losses unless it takes some action. Management desperately searches for an "angel" by offering to be a captive company to one of its larger customers in order to guarantee the company's continued existence with a long-term contract. In this way, the corporation may be able to reduce the scope of some of its functional activities, such as marketing, thus significantly reducing costs. The weaker company gains certainty of sales and production in return for becoming heavily dependent on another firm for at least 75% of its sales. For example, to become the sole supplier of an auto part to General Motors, Simpson Industries of Birmingham, Michigan, agreed to let a special team from GM inspect its engine parts facilities and books and interview its employees. In return, nearly 80% of the company's production was sold to GM through long-term contracts.[66]

Sell-Out/Divestment Strategy

If a corporation with a weak competitive position in an industry is unable either to pull itself up by its bootstraps or to find a customer to which it can become a captive company, it may have no choice but to sell out. The **sell-out strategy** makes sense if management can still obtain a good price for its shareholders and the employees can keep their jobs by selling the entire company to another firm. The hope is that another company will have the necessary resources and determination to return the company to profitability. Marginal performance in a troubled industry was one reason Northwest Airlines was willing to be acquired by Delta Airlines in 2008.

If the corporation has multiple business lines and it chooses to sell off a division with low growth potential, this is called **divestment**. This was the strategy Ford used when it sold its struggling Jaguar and Land Rover units to Tata Motors in 2008 for $2 billion. Ford had spent $10 billion trying to turn around Jaguar after spending $2.5 billion to buy it in 1990. In addition, Ford had paid $2.8 billion for Land Rover in 2000. Ford's management hoped to use the proceeds of the sale to help the company reach profitability in 2009.[67] General Electric's management used the same reasoning when it decided to sell or spin off its slow-growth appliance business in 2008.

Divestment is often used after a corporation acquires a multi-unit corporation in order to shed the units that do not fit with the corporation's new strategy. This is why Whirlpool sold Maytag's Hoover vacuum cleaner unit after Whirlpool purchased Maytag. Divestment was also a key part of Lego's turnaround strategy when management decided to divest its theme parks to concentrate more on its core business of making toys.[68]

Bankruptcy/Liquidation Strategy

When a company finds itself in the worst possible situation with a poor competitive position in an industry with few prospects, management has only a few alternatives—all of them distasteful. Because no one is interested in buying a weak company in an unattractive industry, the firm must pursue a bankruptcy or liquidation strategy. **Bankruptcy** involves giving up management of the firm to the courts in return for some settlement of the corporation's obligations. Top management hopes that once the court decides the claims on the company, the

company will be stronger and better able to compete in a more attractive industry. Faced with a recessionary economy and falling market demand for casual dining, restaurants like Bennigan's Grill & Tavern and Steak & Ale, that once thrived by offering mid-priced menus with potato skins and thick hamburgers, filed for bankruptcy in July 2008. Within the troubled airline industry, at least 30 airlines went bankrupt during just the first half of 2008 with 30 more bankruptcies expected by the end of the year.[69] A controversial approach was used by Delphi Corporation when it filed for Chapter 11 bankruptcy only for its U.S. operations, which employed 32,000 high-wage union workers, but not for its foreign factories in low-wage countries.[70]

In contrast to bankruptcy, which seeks to perpetuate a corporation, **liquidation** is the termination of the firm. When the industry is unattractive and the company too weak to be sold as a going concern, management may choose to convert as many saleable assets as possible to cash, which is then distributed to the shareholders after all obligations are paid. Liquidation is a prudent strategy for distressed firms with a small number of choices, all of which are problematic.[71] This was Circuit City's situation in 2008, when it liquidated its retail stores. The benefit of liquidation over bankruptcy is that the board of directors, as representatives of the shareholders, together with top management make the decisions instead of turning them over to the bankruptcy court, which may choose to ignore shareholders completely.

At times, top management must be willing to select one of these less desirable retrenchment strategies. Unfortunately, many top managers are unwilling to admit that their company has serious weaknesses for fear that they may be personally blamed. Even worse, top management may not even perceive that crises are developing. When these top managers eventually notice trouble, they are prone to attribute the problems to temporary environmental disturbances and tend to follow profit strategies. Even when things are going terribly wrong, top management is greatly tempted to avoid liquidation in the hope of a miracle. Top management enters a *cycle of decline,* in which it goes through a process of secrecy and denial, followed by blame and scorn, avoidance and turf protection, ending with passivity and helplessness.[72] Thus, a corporation needs a strong board of directors who, to safeguard shareholders' interests, can tell top management when to quit.

7.3 Portfolio Analysis

Chapter 6 dealt with how individual product lines and business units can gain competitive advantage in the marketplace by using competitive and cooperative strategies. Companies with multiple product lines or business units must also ask themselves how these various products and business units should be managed to boost overall corporate performance:

- How much of our time and money should we spend on our best products and business units to ensure that they continue to be successful?
- How much of our time and money should we spend developing new costly products, most of which will never be successful?

One of the most popular aids to developing corporate strategy in a multiple-business corporation is portfolio analysis. Although its popularity has dropped since the 1970s and 1980s, when more than half of the largest business corporations used portfolio analysis, it is still used by around 27% of Fortune 500 firms in corporate strategy formulation.[73] Portfolio analysis puts corporate headquarters into the role of an internal banker. In **portfolio analysis**, top management views its product lines and business units as a series of investments from which it expects a profitable return. The product lines/business units form a portfolio of investments that top management must constantly juggle to ensure the best return on the corporation's invested money. A McKinsey & Company study of the performance of the 200 largest U.S. corporations

found that companies that actively managed their business portfolios through acquisitions and divestitures created substantially more shareholder value than those companies that passively held their businesses.[74] Given the increasing number of strategic alliances in today's corporations, portfolio analysis is also being used to evaluate the contribution of alliances to corporate and business unit objectives.

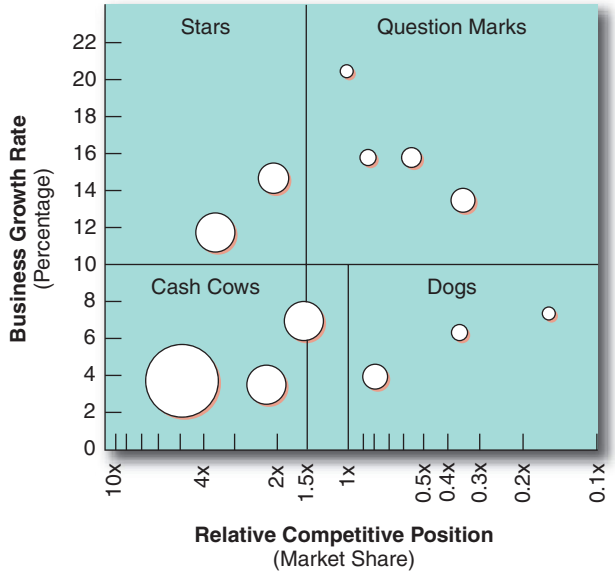
Two of the most popular portfolio techniques are the BCG Growth-Share Matrix and GE Business Screen.

BCG GROWTH-SHARE MATRIX

Using the **BCG (Boston Consulting Group) Growth-Share Matrix** depicted in **Figure 7–3** is the simplest way to portray a corporation's portfolio of investments. Each of the corporation's product lines or business units is plotted on the matrix according to both the growth rate of the industry in which it competes and its relative market share. A unit's relative competitive position is defined as its market share in the industry divided by that of the largest other competitor. By this calculation, a relative market share above 1.0 belongs to the market leader. The business growth rate is the percentage of market growth, that is, the percentage by which sales of a particular business unit classification of products have increased. The matrix assumes that, other things being equal, a growing market is attractive.

The line separating areas of high and low relative competitive position is set at 1.5 times. A product line or business unit must have relative strengths of this magnitude to ensure that it will have the dominant position needed to be a "star" or "cash cow." On the other hand, a product line or unit having a relative competitive position less than 1.0 has "dog" status.[75] Each product or unit is represented in Figure 7–3 by a circle. The area of the circle represents the relative significance of each business unit or product line to the corporation in terms of assets used or sales generated.

FIGURE 7–3
BCG Growth-Share Matrix

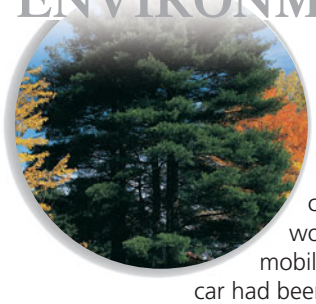


SOURCE: *Reprinted from* Long Range Planning, *Vol. 10, No. 2, 1977, Hedley, "Strategy and the Business Portfolio," p. 12. Copyright © 1977 with permission from Elsevier.*

The BCG Growth-Share Matrix has a lot in common with the product life cycle. As a product moves through its life cycle, it is categorized into one of four types for the purpose of funding decisions:

- **Question marks** (sometimes called "problem children" or "wildcats") are new products with the potential for success, but they need a lot of cash for development. If such a product is to gain enough market share to become a market leader and thus a star, money must be taken from more mature products and spent on the question mark. This is a "fish or cut bait" decision in which management must decide if the business is worth the investment needed. For example, after years of fruitlessly experimenting with an electric car, General Motors finally decided in 2006 to take a chance on developing the Chevrolet Volt.[76] To learn more of GM's decision to build the electric car, see the **Environmental Sustainability Issue** feature.
- **Stars** are market leaders that are typically at the peak of their product life cycle and are able to generate enough cash to maintain their high share of the market and usually contribute to the company's profits. HP's printer business has been called HP's "crown jewel" because of its 41% market share in printers and its control of the replacement cartridge

ENVIRONMENTAL sustainability issue



GENERAL MOTORS AND THE ELECTRIC CAR

In 2003, top management at General Motors (GM) decided to discontinue further work on its EV1 electric automobile. Working versions of the car had been leased to a limited number of people, but never sold. Environmentalists protested that GM stopped making the car just to send a message to government policy makers that an electric car was bad business. Management responded by stating that the car would never have made a profit.

In an April 2005 meeting of GM's top management team, Vice Chairman Robert Lutz suggested that it might be time to build another electric car. He noted that Toyota's Prius hybrid had made Toyota look environmentally sensitive; whereas, GM was viewed as making gas "hogs." The response was negative. Lutz recalled one executive saying, "We lost $1 billion on the last one. Do you want to lose $1 billion on the next one?"

Even though worldwide car ownership was growing 5% annually, rising fuel prices in 2005 reduced sales of GM's profitable SUVs—resulting in a loss of $11 billion. Board members began signaling that it was time for management to take some riskier bets to get the company out of financial trouble. In February 2006, management reluctantly approved developmental work on another electric car. At the time, no one in GM knew if batteries could be made small enough to power a car, but they knew that choices were limited. According to Larry Burns, Vice President of R&D and Strategic Planning, "This industry is 98% dependent on petroleum. GM has concluded that that's not sustainable."

Chairman and CEO Richard Wagoner, Jr. surprised the world at the January 2007 Detroit Auto Show with a vow to start developing an electric car called the Chevrolet Volt. It would plug into a regular electric outlet, leapfrog the competition, and be on sale in 2010. The company not only needed to build a radical new car, but had to convert as much as 75% of its current fleet to hybrid engines to meet fuel economy rules taking effect in 2017.

Management created a new team dedicated to getting hybrid and electric cars to market. The R&D budget was increased from $6.6 billion in 2006 to $8.1 billion in 2007. Several new models were canceled to free resources. The battery lab was under pressure to design batteries that could propel the Volt 40 miles before a small gasoline engine would re-charge the battery and extend the range to 600 miles. Douglas Drauch, battery lab manager, promised that the batteries would be ready on schedule. "We're making history," he said. "Fifty years from now, people will remember the Volt—like they remember a '53 Corvette."

SOURCES: D. Welch, "GM: Live Green or Die," *Business Week* (May 26, 2008), pp. 36–41; "The Drive for Low Emissions," *The Economist's Special Report on Business and Climate Change* (June 2, 2007), pp. 26–28.

market. On its own, it accounted for more than half of HP's operating profit.[77] When a star's market growth rate slows, it becomes a cash cow.

- **Cash cows** typically bring in far more money than is needed to maintain their market share. In this declining stage of their life cycle, these products are "milked" for cash that will be invested in new question marks. Expenses such as advertising and R&D are reduced. Panasonic's video cassette recorders (VCRs) moved to this category when sales declined and DVD player/recorders replaced them. Question marks unable to obtain dominant market share (and thus become stars) by the time the industry growth rate inevitably slows become dogs.
- **Dogs** have low market share and do not have the potential (because they are in an unattractive industry) to bring in much cash. According to the BCG Growth-Share Matrix, dogs should be either sold off or managed carefully for the small amount of cash they can generate. For example, DuPont, the inventor of nylon, sold its textiles unit in 2003 because the company wanted to eliminate its low-margin products and focus more on its growing biotech business.[78] The same was true of IBM when it sold its PC business to China's Lenovo Group in order to emphasize its growing services business.

Underlying the BCG Growth-Share Matrix is the concept of the experience curve (discussed in **Chapter 5**). The key to success is assumed to be market share. Firms with the highest market share tend to have a cost leadership position based on economies of scale, among other things. If a company is able to use the experience curve to its advantage, it should be able to manufacture and sell new products at a price low enough to garner early market share leadership (assuming no successful imitation by competitors). Once the product becomes a star, it is destined to be very profitable, considering its inevitable future as a cash cow.

Having plotted the current positions of its product lines or business units on a matrix, a company can project its future positions, assuming no change in strategy. Present and projected matrixes can thus be used to help identify major strategic issues facing the organization. The goal of any company is to maintain a balanced portfolio so it can be self-sufficient in cash and always working to harvest mature products in declining industries to support new ones in growing industries.

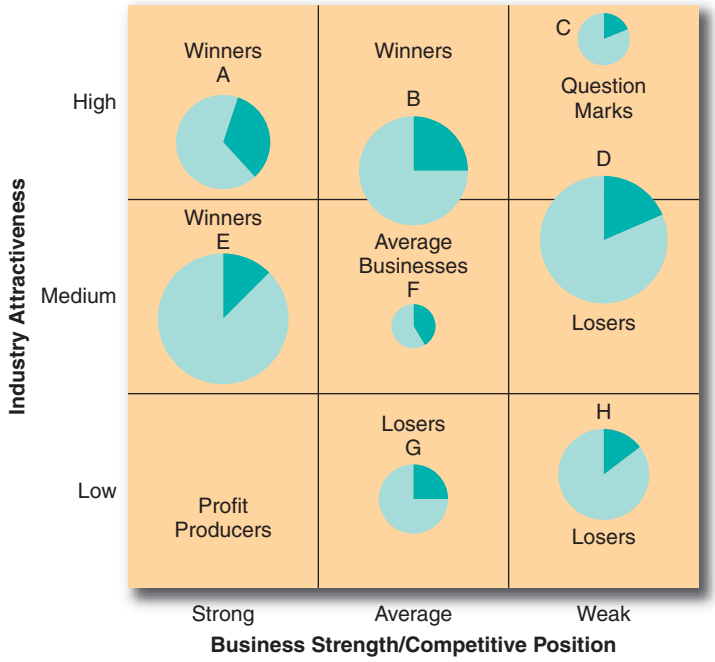
The BCG Growth-Share Matrix is a very well-known portfolio concept with some clear advantages. It is quantifiable and easy to use. *Cash cow, dog, question mark,* and *star* are easy-to-remember terms for referring to a corporation's business units or products. Unfortunately, the BCG Growth-Share Matrix also has some serious limitations:

- The use of highs and lows to form four categories is too simplistic.
- The link between market share and profitability is questionable.[79] Low-share businesses can also be profitable.[80] For example, Olivetti is still profitably selling manual typewriters through mail-order catalogs.
- Growth rate is only one aspect of industry attractiveness.
- Product lines or business units are considered only in relation to one competitor: the market leader. Small competitors with fast-growing market shares are ignored.
- Market share is only one aspect of overall competitive position.

GE BUSINESS SCREEN

General Electric, with the assistance of the McKinsey & Company consulting firm, developed a more complicated matrix. As depicted in **Figure 7–4**, the **GE Business Screen** includes nine cells based on long-term industry attractiveness and business strength competitive position. The GE Business Screen, in contrast to the BCG Growth-Share Matrix, includes much more

FIGURE 7–4
General Electric's Business Screen



SOURCE: *Adapted from* Strategic Management in GE, *Corporate Planning and Development, General Electric Corporation, Reprinted by permission of General Electric Company.*

data in its two key factors than just business growth rate and comparable market share. For example, at GE, industry attractiveness includes market growth rate, industry profitability, size, and pricing practices, among other possible opportunities and threats. Business strength or competitive position includes market share as well as technological position, profitability, and size, among other possible strengths and weaknesses.[81]

The individual product lines or business units are identified by a letter and plotted as circles on the GE Business Screen. The area of each circle is in proportion to the size of the industry in terms of sales. The pie slices within the circles depict the market shares of the product lines or business units.

To plot product lines or business units on the GE Business Screen, follow these four steps:

1. Select criteria to rate the industry for each product line or business unit. Assess overall industry attractiveness for each product line or business unit on a scale from 1 (very unattractive) to 5 (very attractive).
2. Select the key factors needed for success in each product line or business unit. Assess business strength/competitive position for each product line or business unit on a scale of 1 (very weak) to 5 (very strong).
3. Plot each product line's or business unit's current position on a matrix as that depicted in Figure 7–4.
4. Plot the firm's future portfolio, assuming that present corporate and business strategies remain unchanged. Is there a performance gap between projected and desired portfolios? If so, this gap should serve as a stimulus to seriously review the corporation's current mission, objectives, strategies, and policies.

Overall, the nine-cell GE Business Screen is an improvement over the BCG Growth-Share Matrix. The GE Business Screen considers many more variables and does not lead to

such simplistic conclusions. It recognizes, for example, that the attractiveness of an industry can be assessed in many different ways (other than simply using growth rate), and it thus allows users to select whatever criteria they feel are most appropriate to their situation. This portfolio matrix, however, does have some shortcomings:

- It can get quite complicated and cumbersome.
- The numerical estimates of industry attractiveness and business strength/competitive position give the appearance of objectivity, but they are in reality subjective judgments that may vary from one person to another.
- It cannot effectively depict the positions of new products or business units in developing industries.

ADVANTAGES AND LIMITATIONS OF PORTFOLIO ANALYSIS

Portfolio analysis is commonly used in strategy formulation because it offers certain *advantages:*

- It encourages top management to evaluate each of the corporation's businesses individually and to set objectives and allocate resources for each.
- It stimulates the use of externally oriented data to supplement management's judgment.
- It raises the issue of cash-flow availability for use in expansion and growth.
- Its graphic depiction facilitates communication.

Portfolio analysis does, however, have some very real *limitations* that have caused some companies to reduce their use of this approach:

- Defining product/market segments is difficult.
- It suggests the use of standard strategies that can miss opportunities or be impractical.
- It provides an illusion of scientific rigor when in reality positions are based on subjective judgments.
- Its value-laden terms such as cash cow and dog can lead to self-fulfilling prophecies.
- It is not always clear what makes an industry attractive or where a product is in its life cycle.
- Naively following the prescriptions of a portfolio model may actually reduce corporate profits if they are used inappropriately. For example, General Mills' Chief Executive H. Brewster Atwater cited his company's Bisquick brand of baking mix as a product that would have been written off years ago based on portfolio analysis. "This product is 57 years old. By all rights it should have been overtaken by newer products. But with the proper research to improve the product and promotion to keep customers excited, it's doing very well."[82]

MANAGING A STRATEGIC ALLIANCE PORTFOLIO

Just as product lines/business units form a portfolio of investments that top management must constantly juggle to ensure the best return on the corporation's invested money, strategic alliances can also be viewed as a portfolio of investments—investments of money, time, and energy. The way a company manages these intertwined relationships can significantly influence corporate competitiveness. Alliances are thus recognized as an important source of competitive advantage and superior performance.[83]

Managing groups of strategic alliances is primarily the job of the business unit. Its decisions may escalate, however, to the corporate level. Toman Corporation, for example, has

195 international joint ventures containing 422 alliance partners. According to a Toman executive, "If headquarters is trying to bring us and some other company closer together, they should understand not only our business unit, but also other business units. Sometimes the whole of our company may benefit (from an alliance) but it may not be good for one of our business units. And if it proceeds, headquarters must give some credit to our business unit so that we can agree. But it is not acceptable if they say to us that we are to lose something as a result of the alliance and now we have to make up the difference in one of our other businesses." In this instance the stage is set for negotiations across business units at the corporate level to achieve a broadly supported alliance network management system.[84]

A study of 25 leading European corporations found four tasks of multi-alliance management that are necessary for successful alliance portfolio management:

1. **Developing and implementing a portfolio strategy for each business unit and a corporate policy for managing all the alliances of the entire company:** Alliances are primarily determined by business units. The corporate level develops general rules concerning when, how, and with whom to cooperate. The task of alliance policy is to strategically align all of the corporation's alliance activities with corporate strategy and corporate values. Every new alliance is thus checked against corporate policy before it is approved.
2. **Monitoring the alliance portfolio in terms of implementing business unit strategies and corporate strategy and policies:** Each alliance is measured in terms of achievement of objectives (e.g., market share), financial measures (e.g., profits and cash flow), contributed resource quality and quantity, and the overall relationship. The more a firm is diversified, the less the need for monitoring at the corporate level.
3. **Coordinating the portfolio to obtain synergies and avoid conflicts among alliances:** Because the interdependencies among alliances within a business unit are usually greater than among different businesses, the need for coordination is greater at the business level than at the corporate level. The need for coordination increases as the number of alliances in one business unit and the company as a whole increases, the average number of partners per alliance increases, and/or the overlap of the alliances increases.
4. **Establishing an alliance management system to support other tasks of multi-alliance management:** This infrastructure consists of formalized processes, standardized tools and specialized organizational units. All but two of the 25 companies established centers of competence for alliance management. The centers were often part of a department for corporate development or a department of alliance management at the corporate level. In other corporations, specialized positions for alliance management were created at both the corporate and business unit levels or only at the business unit level. Most corporations prefer a system in which the corporate level provides the methods and tools to support alliances centrally, but decentralizes day-to-day alliance management to the business units.[85]

7.4 Corporate Parenting

Campbell, Goold, and Alexander, authors of *Corporate-Level Strategy: Creating Value in the Multibusiness Company*, contend that corporate strategists must address two crucial questions:

- What businesses should this company own and why?
- What organizational structure, management processes, and philosophy will foster superior performance from the company's business units?[86]

Portfolio analysis typically attempts to answer these questions by examining the attractiveness of various industries and by managing business units for cash flow, that is, by using cash generated from mature units to build new product lines. Unfortunately, portfolio analysis fails to deal with the question of what industries a corporation should enter or with how a corporation can attain synergy among its product lines and business units. As suggested by its name, portfolio analysis tends to primarily view matters financially, regarding business units and product lines as separate and independent investments.

Corporate parenting, in contrast, views a corporation in terms of resources and capabilities that can be used to build business unit value as well as generate synergies across business units. According to Campbell, Goold, and Alexander:

> *Multibusiness companies create value by influencing—or parenting—the businesses they own. The best parent companies create more value than any of their rivals would if they owned the same businesses. Those companies have what we call parenting advantage.*[87]

Corporate parenting generates corporate strategy by focusing on the core competencies of the parent corporation and on the value created from the relationship between the parent and its businesses. In the form of corporate headquarters, the parent has a great deal of power in this relationship. According to Campbell, Goold, and Alexander, if there is a good fit between the parent's skills and resources and the needs and opportunities of the business units, the corporation is likely to create value. If, however, there is not a good fit, the corporation is likely to destroy value.[88] Research indicates that companies that have a good fit between their strategy and their parenting roles are better performers than those companies that do not have a good fit.[89] This approach to corporate strategy is useful not only in deciding what new businesses to acquire but also in choosing how each existing business unit should be best managed. This appears to have been the secret to the success of General Electric under CEO Jack Welch. According to one analyst in 2000, "He and his managers really add value by imposing tough standards of profitability and by disseminating knowledge and best practice quickly around the GE empire. If some manufacturing trick cuts costs in GE's aero-engine repair shops in Wales, he insists it be applied across the group."[90]

The primary job of corporate headquarters is, therefore, to obtain synergy among the business units by providing needed resources to units, transferring skills and capabilities among the units, and coordinating the activities of shared unit functions to attain economies of scope (as in centralized purchasing).[91] This is in agreement with the concept of the learning organization discussed in **Chapter 1** in which the role of a large firm is to facilitate and transfer the knowledge assets and services throughout the corporation.[92] This is especially important given that 75% or more of a modern company's market value stems from its intangible assets—the organization's knowledge and capabilities.[93] At Proctor & Gamble, for example, the various business units are expected to work together to develop innovative products. Crest Whitestrips, which controls 68% of the at-home tooth-whitening market, was based on the P&G laundry division's knowledge of whitening agents.[94]

DEVELOPING A CORPORATE PARENTING STRATEGY

Campbell, Goold, and Alexander recommend that the search for appropriate corporate strategy involves three analytical steps:

1. **Examine each business unit (or target firm in the case of acquisition) in terms of its strategic factors:** People in the business units probably identified the strategic factors when they were generating business strategies for their units. One popular approach is to

establish centers of excellence throughout the corporation. According to Frost, Birkinshaw, and Ensign, a *center of excellence* is "an organizational unit that embodies a set of capabilities that has been explicitly recognized by the firm as an important source of value creation, with the intention that these capabilities be leveraged by and/or disseminated to other parts of the firm."[95]

2. **Examine each business unit (or target firm) in terms of areas in which performance can be improved:** These are considered to be parenting opportunities. For example, two business units might be able to gain economies of scope by combining their sales forces. In another instance, a unit may have good, but not great, manufacturing and logistics skills. A parent company having world-class expertise in these areas could improve that unit's performance. The corporate parent could also transfer some people from one business unit who have the desired skills to another unit that is in need of those skills. People at corporate headquarters may, because of their experience in many industries, spot areas where improvements are possible that even people in the business unit may not have noticed. Unless specific areas are significantly weaker than the competition, people in the business units may not even be aware that these areas could be improved, especially if each business unit monitors only its own particular industry.
3. **Analyze how well the parent corporation fits with the business unit (or target firm):** Corporate headquarters must be aware of its own strengths and weaknesses in terms of resources, skills, and capabilities. To do this, the corporate parent must ask whether it has the characteristics that fit the parenting opportunities in each business unit. It must also ask whether there is a misfit between the parent's characteristics and the critical success factors of each business unit.

HORIZONTAL STRATEGY AND MULTIPOINT COMPETITION

A **horizontal strategy** is a corporate strategy that cuts across business unit boundaries to build synergy across business units and to improve the competitive position of one or more business units.[96] When used to build synergy, it acts like a parenting strategy. When used to improve the competitive position of one or more business units, it can be thought of as a corporate competitive strategy. In **multipoint competition,** large multi-business corporations compete against other large multi-business firms in a number of markets. These multipoint competitors are firms that compete with each other not only in one business unit, but also in a number of business units. At one time or another, a cash-rich competitor may choose to build its own market share in a particular market to the disadvantage of another corporation's business unit. Although each business unit has primary responsibility for its own business strategy, it may sometimes need some help from its corporate parent, especially if the competitor business unit is getting heavy financial support from its corporate parent. In this instance, corporate headquarters develops a horizontal strategy to coordinate the various goals and strategies of related business units.

For example, P&G, Kimberly-Clark, Scott Paper, and Johnson & Johnson (J&J) compete with one another in varying combinations of consumer paper products, from disposable diapers to facial tissue. If (purely hypothetically) J&J had just developed a toilet tissue with which it chose to challenge Procter & Gamble's high-share Charmin brand in a particular district, it might charge a low price for its new brand to build sales quickly. P&G might not choose to respond to this attack on its share by cutting prices on Charmin. Because of Charmin's high market share, P&G would lose significantly more sales dollars in a price war than J&J would with its initially low-share brand. To retaliate, P&G might thus challenge J&J's high-share baby

shampoo with P&G's own low-share brand of baby shampoo in a different district. Once J&J had perceived P&G's response, it might choose to stop challenging Charmin so that P&G would stop challenging J&J's baby shampoo.

Multipoint competition and the resulting use of horizontal strategy may actually slow the development of hypercompetition in an industry. The realization that an attack on a market leader's position could result in a response in another market leads to mutual forbearance in which managers behave more conservatively toward multimarket rivals and competitive rivalry is reduced.[97] In one industry, for example, multipoint competition resulted in firms being less likely to exit a market. "Live and let live" replaced strong competitive rivalry.[98] Multipoint competition is likely to become even more prevalent in the future, as corporations become global competitors and expand into more markets through strategic alliances.[99]

End of Chapter SUMMARY

Corporate strategy is primarily about the choice of direction for the firm as a whole. It deals with three key issues that a corporation faces: (1) the firm's overall orientation toward growth, stability, or retrenchment; (2) the industries or markets in which the firm competes through its products and business units; and (3) the manner in which management coordinates activities and transfers resources and cultivates capabilities among product lines and business units. These issues are dealt with through directional strategy, portfolio analysis, and corporate parenting.

Managers must constantly examine their corporation's entire portfolio of products, businesses, and opportunities as if they were planning to reinvest all of its capital.[100] One example is Cummins, Inc. in 2003 when management decided to invest heavily in the firm's power generation business. Management realized at the time that the global appetite for power was growing far faster than local power grids could provide, especially in the fast-growing developing countries. Unfortunately, power generation was the only one of Cummins' four business units to lose money. Tom Linebarger, Cummins' CFO, took over the power generation unit, cut costs, and reorganized the division around product lines rather than territories. Over the next four years, sales of the company's power generators, ranging from portables for RVs to house-sized machines for factories, more than tripled to $3 billion—20% of the company's total sales. Cummins achieved second place, behind Caterpillar, in the global power generator market. Management decided to grow horizontally by building plants in China and India and making small home generators to sell through mass merchandisers.[101]

ECO-BITS

- Bosch Appliances, the German multinational corporation, was the only U.S. appliance manufacturer whose entire line of major appliances in 2008 was Energy Star qualified in the categories that the program rates. According to Bosch, if the more than 8 million U.S. consumers who purchased a new dishwasher in 2007 had bought a Bosch 800 model instead of a conventional unit, the lifetime energy savings would be equal to preventing 21 billion pounds of CO^2 emissions.[102]
- The green building industry is projected to grow from $2.2 billion in 2006 to $4.7 billion by 2011.[103]

DISCUSSION QUESTIONS

1. How does horizontal growth differ from vertical growth as a corporate strategy? From concentric diversification?
2. What are the tradeoffs between an internal and an external growth strategy? Which approach is best as an international entry strategy?
3. Is stability really a strategy or just a term for no strategy?
4. Compare and contrast SWOT analysis with portfolio analysis.
5. How is corporate parenting different from portfolio analysis? How is it alike? Is it a useful concept in a global industry?

STRATEGIC PRACTICE EXERCISE

On March 14, 2000, Stephen King, the horror writer, published his new book, *Riding the Bullet*, on the Internet before it appeared in print. Within 24 hours, around 400,000 people had downloaded the book—even though most of them needed to download software in order to read the book. The unexpected demand crashed servers. According to Jack Romanos, president of Simon & Schuster, "I don't think anybody could have anticipated how many people were out there who are willing to accept the written word in a paperless format." To many, this announced the coming of the electronic novel. Environmentalists applauded that e-books would soon replace paper books and newspapers, thus reducing pollution coming from paper mills and landfills. The King book was easy to download and took less time than a trip to the bookstore. Critics argued that the King book used the Internet because at 66 pages, it was too short to be a standard printed novel. It was also free, so there was nothing to discourage natural curiosity. Some people in the industry estimated that 75% of those who downloaded the book did not read it.[104]

By 2008, HarperCollins and Random House were offering free online book content. Amazon was selling a $399 Kindle e-book reader for downloadable books costing $10 each, but Apple CEO Steve Jobs described the Kindle as something that filled no void and would "go nowhere." Sales in electronic trade books increased from $5.8 million in 2002 to $20 million in 2006 compared to total 2006 book sales of $25–$30 billion. Borders was market testing the downloading of digital purchases. Tim O'Reilly, coiner of the term *Web 2.0*, had been urging publishers to go digital since the early 1980s, but publishers and authors were still concerned with how they would be paid for the intellectual property they created. Om Malik, senior writer for *Business 2.0* magazine reported that the money earned from advertising clicks related to their blog content was barely enough to cover the costs of blogging. Flat World Knowledge, a new entrepreneurial digital textbook publisher, announced that in 2009 it planned to offer free online textbooks with the hope that the firm would make money selling supplementary materials like study guides. Publishers wondered how an industry built on a 15th century paper technology could make a profitable transition to a 21st century paperless electronic technology.[105]

1. Form into small groups in the class to discuss the future of Internet publishing.
2. Consider the following questions as discussion guides:
   - What are the pros and cons of electronic publishing?
   - What is the impact of electronic publishing on the environment?
   - Should newspaper and book publishers completely convert to electronic publishing over paper? (The *Wall Street Journal* and others publish in both paper and electronic formats. Is this a success?)
   - Would you prefer this textbook and others in an electronic format? How would you prefer to read the book?
   - What business model should publishers use to make money publishing on the Internet?
3. Present your group's conclusions to the class.

KEY TERMS

acquisition (p. 208)
backward integration (p. 208)
bankruptcy (p. 219)
BCG (Boston Consulting Group) Growth-Share Matrix (p. 221)
BOT (Build, Operate, Transfer) concept (p. 214)
captive company strategy (p. 219)
cash cows (p. 223)
concentration (p. 208)
concentric diversification (p. 214)
conglomerate diversification (p. 215)
corporate parenting (p. 227)
corporate strategy (p. 206)
directional strategy (p. 207)
diversification (p. 208)
divestment (p. 219)
dogs (p. 223)
exporting (p. 211)
forward integration (p. 208)
franchising (p. 212)
full integration (p. 209)
GE business screen (p. 223)
green-field development (p. 213)
growth strategy (p. 207)
horizontal growth (p. 211)
horizontal integration (p. 211)
horizontal strategy (p. 228)
joint venture (p. 212)
licensing (p. 212)
liquidation (p. 220)
long-term contracts (p. 210)
management contracts (p. 214)
merger (p. 207)
multipoint competition (p. 228)
no-change strategy (p. 217)
parenting strategy (p. 206)
pause/proceed with caution strategy (p. 217)
portfolio analysis (p. 220)
production sharing (p. 213)
profit strategy (p. 218)
quasi-integration (p. 209)
question marks (p. 222)
retrenchment strategies (p. 207)
sell-out strategy (p. 219)
stability strategy (p. 207)
stars (p. 222)
synergy (p. 214)
taper integration (p. 209)
transaction cost economics (p. 209)
turnaround strategy (p. 218)
turnkey operations (p. 213)
vertical growth (p. 208)
vertical integration (p. 208)

NOTES

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CHAPTER 8

strategy formulation: functional strategy and Strategic Choice

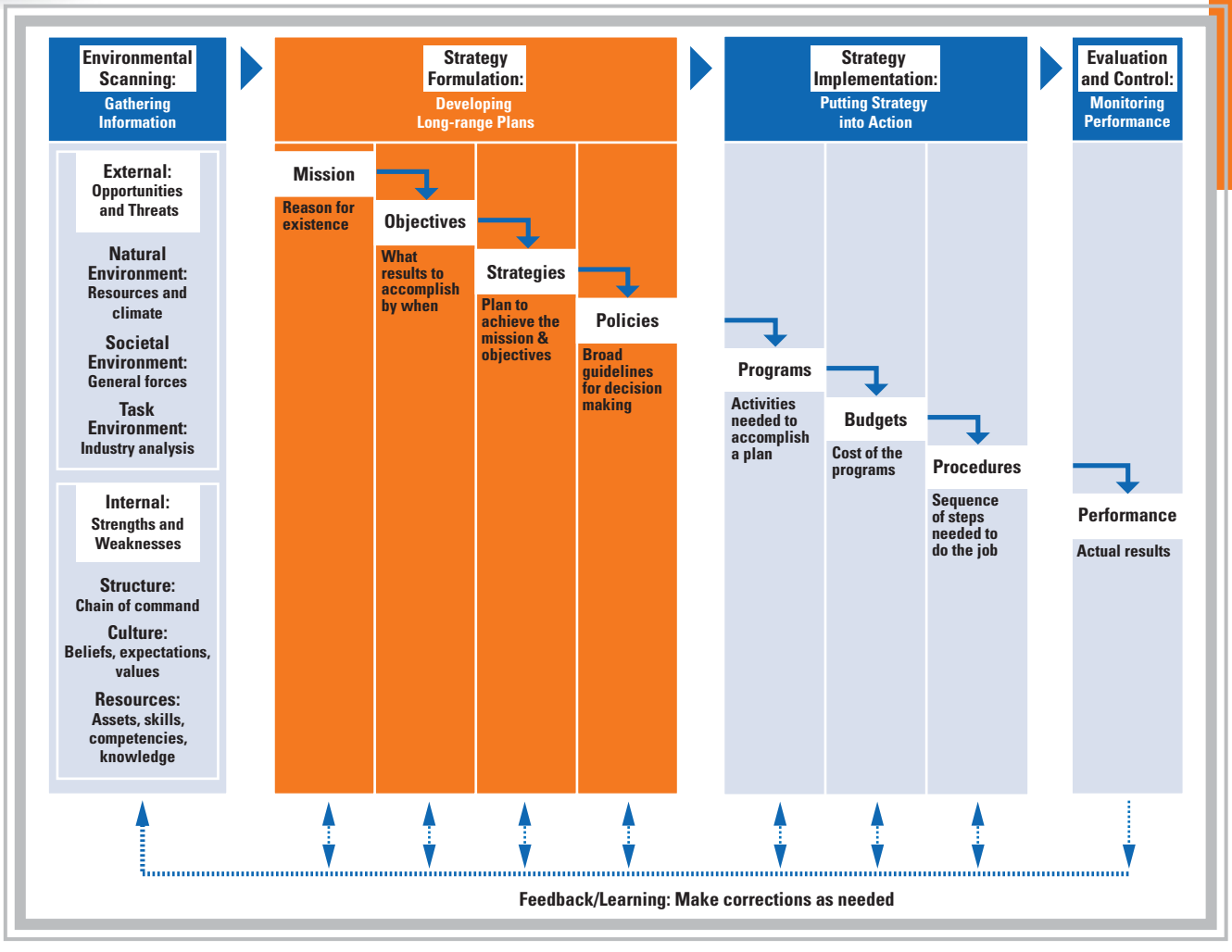
For almost 150 years, the Church & Dwight Company has been building market share on a brand name whose products are in 95% of all U.S. households. Yet if you asked the average person what products this company makes, few would know. Although Church & Dwight may not be a household name, the company's ubiquitous orange box of Arm & Hammer[1] brand baking soda is common throughout North America. Church & Dwight provides a classic example of a marketing functional strategy called *market development*—finding new uses/markets for an existing product. Shortly after its introduction in 1878, Arm & Hammer Baking Soda became a fundamental item on the pantry shelf as people found many uses for sodium bicarbonate other than baking, such as cleaning, deodorizing, and tooth brushing. Hearing of the many uses people were finding for its product, the company advertised that its baking soda was good not only for baking but also for deodorizing refrigerators—simply by leaving an open box in the refrigerator. In a brilliant marketing move, the firm then suggested that consumers buy the product and throw it away—deodorize a kitchen sink by dumping Arm & Hammer baking soda down the drain!

The company did not stop there. It initiated a *product development* strategy by looking for other uses of its sodium bicarbonate in new products. Church & Dwight has achieved consistent growth in sales and earnings through the use of *brand extensions,* putting the Arm & Hammer brand first on baking soda and then on laundry detergents, toothpaste, and deodorants. By the beginning of the 21st century, Church & Dwight had become a significant competitor in markets previously dominated only by giants such as Procter & Gamble, Unilever, and Colgate-Palmolive—using only one brand name. Was there a limit to this growth? Was there a point at which these continuous line extensions would begin to eat away at the integrity of the Arm & Hammer name?

Learning Objectives

After reading this chapter, you should be able to:

- Identify a variety of functional strategies that can be used to achieve organizational goals and objectives
- Understand what activities and functions are appropriate to outsource in order to gain or strengthen competitive advantage
- Recognize strategies to avoid and understand why they are dangerous
- Construct corporate scenarios to evaluate strategic options
- Use a stakeholder priority matrix to aid in strategic decision making
- Develop policies to implement corporate, business, and functional strategies



8.1 Functional Strategy

Functional strategy is the approach a functional area takes to achieve corporate and business unit objectives and strategies by maximizing resource productivity. It is concerned with developing and nurturing a distinctive competence to provide a company or business unit with a competitive advantage. Just as a multidivisional corporation has several business units, each with its own business strategy, each business unit has its own set of departments, each with its own functional strategy.

The orientation of a functional strategy is dictated by its parent business unit's strategy.[2] For example, a business unit following a competitive strategy of differentiation through high quality needs a manufacturing functional strategy that emphasizes expensive quality assurance processes over cheaper, high-volume production; a human resource functional strategy that emphasizes the hiring and training of a highly skilled, but costly, workforce; and a marketing functional strategy that emphasizes distribution channel "pull," using advertising to increase consumer demand, over "push," using promotional allowances to retailers. If a business unit were to follow a low-cost competitive strategy, however, a different set of functional strategies would be needed to support the business strategy.

Just as competitive strategies may need to vary from one region of the world to another, functional strategies may need to vary from region to region. When Mr. Donut expanded into Japan, for example, it had to market donuts not as breakfast, but as snack food. Because the Japanese had no breakfast coffee-and-donut custom, they preferred to eat the donuts in the afternoon or evening. Mr. Donut restaurants were thus located near railroad stations and supermarkets. All signs were in English to appeal to the Western interests of the Japanese.

MARKETING STRATEGY

Marketing strategy deals with pricing, selling, and distributing a product. Using a **market development** strategy, a company or business unit can (1) capture a larger share of an existing market for current products through market saturation and market penetration or (2) develop new uses and/or markets for current products. Consumer product giants such as P&G, Colgate-Palmolive, and Unilever are experts at using advertising and promotion to implement a market saturation/penetration strategy to gain the dominant market share in a product category. As seeming masters of the product life cycle, these companies are able to extend product life almost indefinitely through "new and improved" variations of product and packaging that appeal to most market niches. A company, such as Arm & Hammer, follows the second market development strategy by finding new uses for its successful current product, baking soda.

Using the **product development** strategy, a company or unit can (1) develop new products for *existing markets* or (2) develop new products for *new markets*. Church & Dwight has had great success by following the first product development strategy developing new products to sell to its current customers in its existing markets. Acknowledging the widespread appeal of its Arm & Hammer brand baking soda, the company has generated new uses for its sodium bicarbonate by reformulating it as toothpaste, deodorant, and detergent. In another example, Ocean Spray developed craisans, mock berries, light cranberry juices, and juice boxes in order to market its cranberries to current customers.[3] Using a successful brand name to market other products is called *brand extension*, and it is a good way to appeal to a company's current customers. Smith & Wesson, famous for its handguns, has taken this approach by using licensing to put its name on men's cologne and other products like the Smith & Wesson 357 Magnum Wood Pellet Smoker (for smoking meats).[4] Arm & Hammer has successfully followed the second product development strategy (new products for new markets) by

developing new pollution-reduction products (using sodium bicarbonate compounds) for sale to coal-fired electric utility plants—a very different market from grocery stores.

There are numerous other marketing strategies. For advertising and promotion, for example, a company or business unit can choose between "push" and "pull" marketing strategies. Many large food and consumer products companies in the United States and Canada follow a *push strategy* by spending a large amount of money on trade promotion in order to gain or hold shelf space in retail outlets. Trade promotion includes discounts, in-store special offers, and advertising allowances designed to "push" products through the distribution system. The Kellogg Company decided a few years ago to change its emphasis from a push to a *pull strategy*, in which advertising "pulls" the products through the distribution channels. The company now spends more money on consumer advertising designed to build brand awareness so that shoppers will ask for the products. Research has found that a high level of advertising (a key part of a pull strategy) is beneficial to leading brands in a market.[5] Strong brands provide a competitive advantage to a firm because they act as entry barriers and usually generate high market share.[6]

Other marketing strategies deal with distribution and pricing. Should a company use distributors and dealers to sell its products, or should it sell directly to mass merchandisers or use the direct marketing model by selling straight to the consumers via the Internet? Using multiple channels simultaneously can lead to problems. In order to increase the sales of its lawn tractors and mowers, for example, John Deere decided to sell the products not only through its current dealer network but also through mass merchandisers such as Home Depot. Deere's dealers, however, were furious. They considered Home Depot to be a key competitor. The dealers were concerned that Home Depot's ability to underprice them would eventually lead to their becoming little more than repair facilities for their competition and left with insufficient sales to stay in business.[7]

When pricing a new product, a company or business unit can follow one of two strategies. For new-product pioneers, *skim pricing* offers the opportunity to "skim the cream" from the top of the demand curve with a high price while the product is novel and competitors are few. *Penetration pricing*, in contrast, attempts to hasten market development and offers the pioneer the opportunity to use the experience curve to gain market share with a low price and then dominate the industry. Depending on corporate and business unit objectives and strategies, either of these choices may be desirable to a particular company or unit. Penetration pricing is, however, more likely than skim pricing to raise a unit's operating profit in the long term.[8] The use of the Internet to market goods directly to consumers allows a company to use *dynamic pricing*, a practice in which prices vary frequently based upon demand, market segment, and product availability.[9]

FINANCIAL STRATEGY

Financial strategy examines the financial implications of corporate and business-level strategic options and identifies the best financial course of action. It can also provide competitive advantage through a lower cost of funds and a flexible ability to raise capital to support a business strategy. Financial strategy usually attempts to maximize the financial value of a firm.

The trade-off between achieving the desired debt-to-equity ratio and relying on internal long-term financing via cash flow is a key issue in financial strategy. Many small- and medium-sized family-owned companies such as Urschel Laboratories try to avoid all external sources of funds in order to avoid outside entanglements and to keep control of the company within the family. Few large publicly-held firms have no long-term debt and instead keep a large amount of money in cash and short-term investments. One of these is Apple, Inc. According to Apple's Chief Financial Officer, Peter Oppenheimer, "Our preference is to maintain a strong balance sheet in order to preserve our flexibility."[10] Many financial analysts believe, however, that only by financing through long-term debt can a corporation use financial leverage to boost earnings

per share—thus raising stock price and the overall value of the company. Research indicates that higher debt levels not only deter takeover by other firms (by making the company less attractive) but also lead to improved productivity and improved cash flows by forcing management to focus on core businesses.[11] High debt can be a problem, however, when the economy falters and a company's cash flow drops.

Research reveals that a firm's financial strategy is influenced by its corporate diversification strategy. Equity financing, for example, is preferred for related diversification, whereas debt financing is preferred for unrelated diversification.[12] The trend away from unrelated to related acquisitions explains why the number of acquisitions being paid for entirely with stock increased from only 2% in 1988 to 50% in 1998.[13]

A very popular financial strategy is the leveraged buyout (LBO). During 2006 and 2007, for example, the total value of LBOs was $1.4 trillion, about one-third of all the buyouts ever done.[14] In a **leveraged buyout**, a company is acquired in a transaction financed largely by debt, usually obtained from a third party, such as an insurance company or an investment banker. Ultimately the debt is paid with money generated from the acquired company's operations or by sales of its assets. The acquired company, in effect, pays for its own acquisition. Management of the LBO is then under tremendous pressure to keep the highly leveraged company profitable. Unfortunately, the huge amount of debt on the acquired company's books may actually cause its eventual decline by focusing management's attention on short-term matters. For example, one year after the buyout, the cash flow of eight of the largest LBOs made during 2006–2007 was barely enough to cover interest payments.[15] One study of LBOs (also called MBOs—Management BuyOuts) revealed that the financial performance of the typical LBO usually falls below the industry average in the fourth year after the buyout. The firm declines because of inflated expectations, utilization of all slack, management burnout, and a lack of strategic management.[16] Often the only solutions are to sell the company or to again go public by selling stock to finance growth.[17]

The management of dividends and stock price is an important part of a corporation's financial strategy. Corporations in fast-growing industries such as computers and computer software often do not declare dividends. They use the money they might have spent on dividends to finance rapid growth. If the company is successful, its growth in sales and profits is reflected in a higher stock price, eventually resulting in a hefty capital gain when shareholders sell their common stock. Other corporations, such as Whirlpool Corporation, that do not face rapid growth, must support the value of their stock by offering consistent dividends. Instead of raising dividends when profits are high, a popular financial strategy is to use excess cash (or even use debt) to buy back a company's own shares of stock. During 2005, for example, 1,012 U.S.-based publicly traded companies declared $446 billion worth of stock repurchase plans. Because stock buybacks increase earnings per share, they typically increase a firm's stock price and make unwanted takeover attempts more difficult. Such buybacks do signal, however, that either management may not have been able to find any profitable investment opportunities for the company or that it is anticipating reduced future earnings.[18]

A number of firms have been supporting the price of their stock by using *reverse stock splits*. Contrasted with a typical forward 2-for-1 stock split in which an investor receives an additional share for every share owned (with each share being worth only half as much), in a reverse 1-for-2 stock split, an investor's shares are split in half for the same total amount of money (with each share now being worth twice as much). Thus, 100 shares of stock worth $10 each are exchanged for 50 shares worth $20 each. A reverse stock split may successfully raise a company's stock price, but it does not solve underlying problems. A study by Credit Suisse First Boston revealed that almost all 800 companies that had reverse stock splits in a five-year period underperformed their peers over the long term.[19]

A rather novel financial strategy is the selling of a company's patents. Companies such as AT&T, Bellsouth, American Express, Kimberly Clark, and 3Com have been selling patents for products that they no longer wish to commercialize or are not a part of their core business.

They use an intermediary, like Chicago-based Ocean Tomo, to group the patents into lots related to a common area and sell them to the highest bidder.[20]

RESEARCH AND DEVELOPMENT (R&D) STRATEGY

R&D strategy deals with product and process innovation and improvement. It also deals with the appropriate mix of different types of R&D (basic, product, or process) and with the question of how new technology should be accessed—through internal development, external acquisition, or strategic alliances.

One of the R&D choices is to be either a **technological leader,** pioneering an innovation, or a **technological follower,** imitating the products of competitors. Porter suggests that deciding to become a technological leader or follower can be a way of achieving either overall low cost or differentiation. (See **Table 8–1.**)

One example of an effective use of the *leader* R&D functional strategy to achieve a differentiation competitive advantage is Nike, Inc. Nike spends more than most in the industry on R&D to differentiate the performance of its athletic shoes from that of its competitors. As a result, its products have become the favorite of serious athletes. An example of the use of the *follower* R&D functional strategy to achieve a low-cost competitive advantage is Dean Foods Company. "We're able to have the customer come to us and say, 'If you can produce X, Y, and Z product for the same quality and service, but at a lower price and without that expensive label on it, you can have the business,'" says Howard Dean, president of the company.[21]

An increasing number of companies are working with their suppliers to help them keep up with changing technology. They are beginning to realize that a firm cannot be competitive technologically only through internal development. For example, Chrysler Corporation's skillful use of parts suppliers to design everything from car seats to drive shafts has enabled it to spend consistently less money than its competitors to develop new car models. Using strategic technology alliances is one way to combine the R&D capabilities of two companies. Maytag Company worked with one of its suppliers to apply fuzzy logic technology to its IntelliSense™ dishwasher. The partnership enabled Maytag to complete the project in a shorter amount of time than if it had tried to do it alone.[22] One UK study found that 93% of UK auto assemblers and component manufacturers use their suppliers as technology suppliers.[23]

A new approach to R&D is *open innovation*, in which a firm uses alliances and connections with corporate, government, academic labs, and even consumers to develop new products and processes. For example, Intel opened four small-scale research facilities adjacent to universities to promote the cross-pollination of ideas. Thirteen U.S. university labs engaging

TABLE 8–1

Research and Development Strategy and Competitive Advantage

	Technological Leadership	Technological Followership
Cost Advantage	Pioneer the lowest-cost production design. Be the first down the learning curve. Create low cost ways of performing value activities.	Lower the cost of the product or value activities by learning from the leader's experience. Avoid R & D costs through imitation.
Differentiation	Pioneer a unique product that increases buyer value. Innovate in other activities to increase buyer value.	Adapt the product or delivery system more closely to buyer needs by learning from the leader's experience.

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in nanotechnology research have formed the National Nanotechnology Infrastructure Network in order to offer their resources to businesses for a fee.[24] Mattel, Wal-Mart, and other toy manufacturers and retailers use idea brokers such as Big Idea Group to scout for new toy ideas. Big Idea Group invites inventors to submit ideas to its Web site (www.bigideagroup.net). It then refines and promotes to its clients the most promising ideas.[25] IBM adopted the open operating system Linux for some of its computer products and systems, drawing on a core code base that is continually improved and enhanced by a massive global community of software developers, of whom only a fraction work for IBM.[26] To open its own labs to ideas being generated elsewhere, P&G's CEO Art Lafley decreed that half of the company's ideas must come from outside, up from 10% in 2000. P&G instituted the use of *technology scouts* to search beyond the company for promising innovations. By 2007, the objective was achieved: 50% of the company's innovations originated outside P&G.[27]

A slightly different approach to technology development is for a large firm such as IBM or Microsoft to purchase minority stakes in relatively new high-tech entrepreneurial ventures that need capital to continue operation. Investing corporate venture capital is one way to gain access to promising innovations at a lower cost than by developing them internally.[28]

OPERATIONS STRATEGY

Operations strategy determines how and where a product or service is to be manufactured, the level of vertical integration in the production process, the deployment of physical resources, and relationships with suppliers. It should also deal with the optimum level of technology the firm should use in its operations processes. See the **Global Issue** feature to see how differences in national conditions can lead to differences in product design and manufacturing facilities from one country to another.

Advanced Manufacturing Technology (AMT) is revolutionizing operations worldwide and should continue to have a major impact as corporations strive to integrate diverse business activities by using computer assisted design and manufacturing (CAD/CAM) principles. The use of CAD/CAM, flexible manufacturing systems, computer numerically controlled systems, automatically guided vehicles, robotics, manufacturing resource planning (MRP II), optimized production technology, and just-in-time techniques contribute to increased flexibility, quick response time, and higher productivity. Such investments also act to increase the company's fixed costs and could cause significant problems if the company is unable to achieve economies of scale or scope. Baldor Electric Company, the largest maker of industrial electric motors in the United States, built a new factory by using the new technology to eliminate undesirable jobs with high employee turnover. With one-tenth the employees of its foreign plants, the plant was cost-competitive with motors produced in Mexico or China.[29]

A firm's manufacturing strategy is often affected by a product's life cycle. As the sales of a product increase, there will be an increase in production volume ranging from lot sizes as low as one in a *job shop* (one-of-a-kind production using skilled labor) through *connected line batch flow* (components are standardized; each machine functions such as a job shop but is positioned in the same order as the parts are processed) to lot sizes as high as 100,000 or more per year for *flexible manufacturing systems* (parts are grouped into manufacturing families to produce a wide variety of mass-produced items) and *dedicated transfer lines* (highly automated assembly lines making one mass-produced product using little human labor). According to this concept, the product becomes standardized into a commodity over time in conjunction with increasing demand. Flexibility thus gives way to efficiency.[30]

Increasing competitive intensity in many industries has forced companies to switch from traditional mass production using dedicated transfer lines to a continuous improvement production strategy. A *mass-production* system was an excellent method to produce a large number of low-cost, standard goods and services. Employees worked on narrowly defined,

GLOBAL issue

INTERNATIONAL DIFFERENCES ALTER WHIRLPOOL'S OPERATIONS STRATEGY

To better penetrate the growing markets in developing nations, Whirlpool decided to build a "world washer." This new type of washing machine was to be produced in Brazil, Mexico, and India. Lightweight, with substantially fewer parts than its U.S. counterpart, its performance was to be equal to or better than anything on the world market while being competitive in price with the most popular models in these markets. The goal was to develop a complete product, process, and facility design package that could be used in different countries with low initial investment. Originally the plan had been to make the same low-cost washer in identical plants in each of the three countries.

Significant differences in each of the three countries forced Whirlpool to change its product design to adapt to each nation's situation. According to Lawrence Kremer, Senior Vice President of Global Technology and Operations, "Our Mexican affiliate, Vitromatic, has porcelain and glass-making capabilities. Porcelain baskets made sense for them. Stainless steel became the preferred material for the others." Costs also affected decisions. "In India, for example, material costs may run as much as 200% to 800% higher than elsewhere, while labor and overhead costs are comparatively minimal," added Kremer. Another consideration was the garments to be washed in each country. For example, saris—the 18-foot lengths of cotton or silk with which Indian women drape themselves—needed special treatment in an Indian washing machine, forcing additional modifications.

Manufacturing facilities also varied from country to country. Brastemp, Whirlpool's Brazilian partner, built its plant of precast concrete to address the problems of high humidity. In India, however, the construction crew cast the concrete, allowed it to cure, and then using chain, block, and tackle, five or six men raised each three-ton slab into place. Instead of using one building, Mexican operations used two, one housing the flexible assembly lines and stamping operations, and an adjacent facility housing the injection molding and extrusion processes.

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repetitious tasks under close supervision in a bureaucratic and hierarchical structure. Quality, however, often tended to be fairly low. Learning how to do something better was the prerogative of management; workers were expected only to learn what was assigned to them. This system tended to dominate manufacturing until the 1970s. Under the *continuous improvement* system developed by Japanese firms, empowered cross-functional teams strive constantly to improve production processes. Managers are more like coaches than like bosses. The result is a large quantity of low-cost, standard goods and services, but with high quality. The key to continuous improvement is the acknowledgment that workers' experience and knowledge can help managers solve production problems and contribute to tightening variances and reducing errors. Because continuous improvement enables firms to use the same low-cost competitive strategy as do mass-production firms but at a significantly higher level of quality, it is rapidly replacing mass production as an operations strategy.

The automobile industry is currently experimenting with the strategy of *modular manufacturing* in which preassembled subassemblies are delivered as they are needed (i.e., Just-in-Time) to a company's assembly-line workers, who quickly piece the modules together into a finished product. For example, General Motors built a new automotive complex in Brazil to make its new subcompact, the Celta. Sixteen of the 17 buildings were occupied by suppliers, including Delphi, Lear, and Goodyear. These suppliers delivered preassembled modules (which comprised 85% of the final value of each car) to GM's building for assembly. In a process new to the industry, the suppliers acted as a team to build a single module comprising the motor, transmission, fuel lines, rear axle, brake-fluid lines, and exhaust system, which was then installed as one piece. GM hoped that this manufacturing strategy would enable it

to produce 100 vehicles annually per worker compared to the standard rate of 30 to 50 autos per worker.[31] Ford and Chrysler have also opened similar modular facilities in Brazil.

The concept of a product's life cycle eventually leading to one-size-fits-all mass production is being increasingly challenged by the new concept of mass customization. Appropriate for an ever-changing environment, *mass customization* requires that people, processes, units, and technology reconfigure themselves to give customers exactly what they want, when they want it. In the case of Dell Computer, customers use the Internet to design their own computers. In contrast to continuous improvement, mass customization requires flexibility and quick responsiveness. Managers coordinate independent, capable individuals. An efficient linkage system is crucial. The result is low-cost, high-quality, customized goods and services appropriate for a large number of market niches.

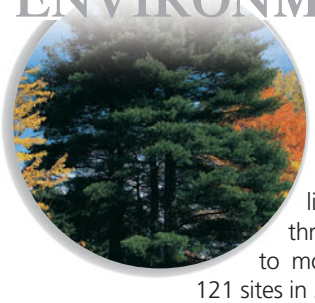
A contentious issue for manufacturing companies throughout the world is the availability of resources needed to operate a modern factory. The increasing cost of oil during 2007 and 2008 drastically boosted costs, only some of which could be passed on to the customers in a competitive environment. The likelihood that fresh water could become an equally scarce resource is causing many companies to rethink water-intensive manufacturing processes. To learn how companies are beginning to deal with increasing fresh water scarcity, see the **Environmental Sustainability Issue** feature.

PURCHASING STRATEGY

Purchasing strategy deals with obtaining the raw materials, parts, and supplies needed to perform the operations function. Purchasing strategy is important because materials and components purchased from suppliers comprise 50% of total manufacturing costs of manufacturing companies in the United Kingdom, United States, Australia, Belgium, and Finland.[32] The basic purchasing choices are multiple, sole, and parallel sourcing. Under *multiple sourcing,* the purchasing company orders a particular part from several vendors. Multiple sourcing has traditionally been considered superior to other purchasing approaches because (1) it forces suppliers to compete for the business of an important buyer, thus reducing purchasing costs, and (2) if one supplier cannot deliver, another usually can, thus guaranteeing that parts and supplies are always on hand when needed. Multiple sourcing has been one way for a purchasing firm to control the relationship with its suppliers. So long as suppliers can provide evidence that they can meet the product specifications, they are kept on the purchaser's list of acceptable vendors for specific parts and supplies. Unfortunately, the common practice of accepting the lowest bid often compromises quality.

W. Edward Deming, a well-known management consultant, strongly recommended *sole sourcing* as the only manageable way to obtain high supplier quality. Sole sourcing relies on only one supplier for a particular part. Given his concern with designing quality into a product in its early stages of development, Deming argued that the buyer should work closely with the supplier at all stages. This reduces both cost and time spent on product design and it also improves quality. It can also simplify the purchasing company's production process by using the *Just-In-Time* (JIT) concept of having the purchased parts arrive at the plant just when they are needed rather than keeping inventories. The concept of sole sourcing is taken one step further in JIT II, in which vendor sales representatives actually have desks next to the purchasing company's factory floor, attend production status meetings, visit the R&D lab, and analyze the purchasing company's sales forecasts. These in-house suppliers then write sales orders for which the purchasing company is billed. Developed by Lance Dixon at Bose Corporation, JIT II is also being used at IBM, Honeywell, and Ingersoll-Rand. Karen Dale, purchasing manager for Honeywell's office supplies, said she was very concerned about confidentiality when JIT II was first suggested to her. Soon she had five suppliers working with her 20 buyers and reported few problems.[33]

ENVIRONMENTAL sustainability issue



OPERATIONS NEED FRESH WATER AND LOTS OF IT!

The U.S. Department of Energy (DOE) plans to build a rail line more than 300 miles long through the Nevada wilderness to move spent nuclear fuel from 121 sites in 39 states to a geologic repository at Yucca Mountain. One of the biggest issues to overcome will be water supply. The DOE estimates that the construction phase would require 5,500 acre feet of water for earthwork compaction, 370 acre-feet for construction personnel, 200 acre-feet for dust control along access roads, and 30 acre-feet for quarry operations, totaling 6,100 acre-feet, or two billion gallons, of water to support a four-year construction period. To meet this need, DOE wants to drill 150 to 176 new wells. The state of Nevada, however, has rejected a permit request to use water for drilling on the Yucca Mountain site, stating that water has to be used for the benefit of the public. Negotiations continue.

This is just one of the ways that organizations need fresh water for their operations. Nestlé, Unilever, Coca-Cola, Anheuser-Busch, and Danone consume almost 575 billion liters of water a year, enough to satisfy the daily water needs of every person on the planet. It takes about 13 cubic meters of freshwater to produce a single 200 mm semiconductor wafer. As a result, chip making is believed to account for 25% of the water consumption in Silicon Valley. According to Jose Lopez, Nestlé's COO, it takes four liters of water to make one liter of product in Nestlé's factories, but 3,000 liters of water are needed to grow the agricultural produce that supplies them. Each year, around 40% of the freshwater withdrawn from lakes and aquifers in America is used to cool power plants. Separating one liter of oil from Canada's tar sands requires up to five liters of water!

"Water is the oil of the 21st century," contends Andrew Liveris, CEO of the chemical company Dow. Like oil, supplies of clean, easily accessible fresh water are under a growing strain because of the growing population and widespread improvements in living standards. Industrialization in developing nations is contaminating rivers and aquifers. Climate change is altering the patterns of fresh water availability so that droughts are more likely in many parts of the world. According to a survey by the Marsh Center for Risk Insights, 40% of Fortune 1000 companies stated that the impact of a water shortage on their business would be "severe" or "catastrophic," but only 17% said that they were prepared for such a crisis. Of Nestlé's 481 factories worldwide, 49 are located in water-scarce regions. Environmental activists have attacked PepsiCo and Coca-Cola for allegedly depleting groundwater in India to make bottled drinks.

There are a number of companies that are taking action to protect their future supply of freshwater. Dow has reduced the amount of water it uses by over a third since 1995. During 1997–2006, when Nestle almost doubled the volume of food it produced, it reduced the amount of water used by 29%. By 2008, Coca-Cola had achieved 85% of its objective to clean all of the wastewater generated at its bottling plants by 2010. China's Elion Chemical is working with General Electric to recycle 90% of its wastewater to comply with the government's new "zero-liquid" discharge rules.

SOURCE: K. Kube, "Into the Wild Brown Yonder," *Trains* (November 2008), pp. 68–73; "Running Dry," *The Economist* (August 23, 2008), pp. 53–54.

Sole sourcing reduces transaction costs and builds quality by having the purchaser and supplier work together as partners rather than as adversaries. With sole sourcing, more companies will have longer relationships with fewer suppliers. Research has found that buyer-supplier collaboration and joint problem solving with both parties dependent upon the other results in the development of competitive capabilities, higher quality, lower costs, and better scheduling.[34] Sole sourcing does, however, have limitations. If a supplier is unable to deliver a part, the purchaser has no alternative but to delay production. Multiple suppliers can provide the purchaser with better information about new technology and performance capabilities. The limitations of sole sourcing have led to the development of parallel sourcing. In *parallel sourcing*, two suppliers are the sole suppliers of two different parts, but they are also backup suppliers for each other's parts. If one vendor cannot supply all of its parts on time, the other vendor is asked to make up the difference.[35]

The Internet is being increasingly used both to find new sources of supply and to keep inventories replenished. For example, Hewlett-Packard introduced a Web-based procurement system to enable its 84,000 employees to buy office supplies from a standard set of suppliers. The new system enabled the company to save $60 to $100 million annually in purchasing costs.[36] Research indicates that companies using Internet-based technologies are able to lower administrative costs and purchase prices.[37]

LOGISTICS STRATEGY

Logistics strategy deals with the flow of products into and out of the manufacturing process. Three trends related to this strategy are evident: centralization, outsourcing, and the use of the Internet. To gain logistical synergies across business units, corporations began centralizing logistics in the headquarters group. This centralized logistics group usually contains specialists with expertise in different transportation modes such as rail or trucking. They work to aggregate shipping volumes across the entire corporation to gain better contracts with shippers. Companies such as Georgia-Pacific, Marriott, and Union Carbide view the logistics function as an important way to differentiate themselves from the competition, to add value, and to reduce costs.

Many companies have found that outsourcing logistics reduces costs and improves delivery time. For example, HP contracted with Roadway Logistics to manage its inbound raw materials warehousing in Vancouver, Canada. Nearly 140 Roadway employees replaced 250 HP workers, who were transferred to other HP activities.[38]

Many companies are using the Internet to simplify their logistical system. For example, Ace Hardware created an online system for its retailers and suppliers. An individual hardware store can now see on the Web site that ordering 210 cases of wrenches is cheaper than ordering 200 cases. Because a full pallet is composed of 210 cases of wrenches, an order for a full pallet means that the supplier doesn't have to pull 10 cases off a pallet and repackage them for storage. There is less chance that loose cases will be lost in delivery, and the paperwork doesn't have to be redone. As a result, Ace's transportation costs are down 18%, and warehouse costs have been cut 28%.[39]

HUMAN RESOURCE MANAGEMENT (HRM) STRATEGY

HRM strategy, among other things, addresses the issue of whether a company or business unit should hire a large number of low-skilled employees who receive low pay, perform repetitive jobs, and are most likely quit after a short time (the McDonald's restaurant strategy) or hire skilled employees who receive relatively high pay and are cross-trained to participate in *self-managing work teams*. As work increases in complexity, the more suited it is for teams, especially in the case of innovative product development efforts. Multinational corporations are increasingly using self-managing work teams in their foreign affiliates as well as in home-country operations.[40] Research indicates that the use of work teams leads to increased quality and productivity as well as to higher employee satisfaction and commitment.[41]

Companies following a competitive strategy of differentiation through high quality use input from subordinates and peers in performance appraisals to a greater extent than do firms following other business strategies.[42] A complete *360-degree appraisal*, in which input is gathered from multiple sources, is now being used by more than 10% of U.S. corporations and has become one of the most popular and effective tools in developing employees and new managers.[43] One Indian company, HCL Technologies, publishes the appraisal ratings for the top 20 managers on the company's intranet for all to see.[44]

Companies are finding that having a *diverse workforce* can be a competitive advantage. Research reveals that firms with a high degree of racial diversity following a growth strategy

have higher productivity than do firms with less racial diversity.[45] Avon Company, for example, was able to turn around its unprofitable inner-city markets by putting African-American and Hispanic managers in charge of marketing to these markets.[46] Diversity in terms of age and national origin also offers benefits. DuPont's use of multinational teams has helped the company develop and market products internationally. McDonald's has discovered that older workers perform as well as, if not better than, younger employees. According to Edward Rensi, CEO of McDonald's USA, "We find these people to be particularly well motivated, with a sort of discipline and work habits hard to find in younger employees."[47]

INFORMATION TECHNOLOGY STRATEGY

Corporations are increasingly using **information technology strategy** to provide business units with competitive advantage. When FedEx first provided its customers with PowerShip computer software to store addresses, print shipping labels, and track package location, its sales jumped significantly. UPS soon followed with its own MaxiShips software. Viewing its information system as a distinctive competency, FedEx continued to push for further advantage over UPS by using its Web site to enable customers to track their packages. FedEx uses this competency in its advertisements by showing how customers can track the progress of their shipments. Soon thereafter, UPS provided the same service. Although it can be argued that information technology has now become so pervasive that it no longer offers companies a competitive advantage, corporations worldwide continue to spend over $2 trillion annually on information technology.[48]

Multinational corporations are finding that having a sophisticated intranet allows employees to practice *follow-the-sun management*, in which project team members living in one country can pass their work to team members in another country in which the work day is just beginning. Thus, night shifts are no longer needed.[49] The development of instant translation software is also enabling workers to have online communication with co-workers in other countries who use a different language.[50] For example, Mattel has cut the time it takes to develop new products by 10% by enabling designers and licensees in other countries to collaborate on toy design. IBM uses its intranet to allow its employees to collaborate and improve their skills, thus reducing its training and travel expenses.[51]

Many companies, such as Lockheed Martin, General Electric, and Whirlpool, use information technology to form closer relationships with both their customers and suppliers through sophisticated extranets. For example, General Electric's Trading Process Network allows suppliers to electronically download GE's requests for proposals, view diagrams of parts specifications, and communicate with GE purchasing managers. According to Robert Livingston, GE's head of worldwide sourcing for the Lighting Division, going on the Web reduces processing time by one-third.[52] Thus, the use of information technology through extranets makes it easier for a company to buy from others (outsource) rather than make it themselves (vertically integrate).[53]

8.2 The Sourcing Decision: Location of Functions

For a functional strategy to have the best chance of success, it should be built on a distinctive competency residing within that functional area. If a corporation does not have a distinctive competency in a particular functional area, that functional area could be a candidate for outsourcing.

Outsourcing is purchasing from someone else a product or service that had been previously provided internally. Thus, it is the reverse of vertical integration. Outsourcing is becoming an increasingly important part of strategic decision making and an important way to increase efficiency and often quality. In a study of 30 firms, outsourcing resulted on average in a 9% reduction

in costs and a 15% increase in capacity and quality.[54] For example, Boeing used outsourcing as a way to reduce the cost of designing and manufacturing its new 787 Dreamliner. Up to 70% of the plane was outsourced. In a break from past practice, suppliers make large parts of the fuselage, including plumbing, electrical, and computer systems, and ship them to Seattle for assembly by Boeing. Outsourcing enabled Boeing to build a 787 in 4 months instead of the usual 12.[55]

According to an American Management Association survey of member companies, 94% of the responding firms outsource at least one activity. The outsourced activities are general and administrative (78%), human resources (77%), transportation and distribution (66%), information systems (63%), manufacturing (56%), marketing (51%), and finance and accounting (18%). The survey also reveals that 25% of the respondents have been disappointed in their outsourcing results. Fifty-one percent of the firms reported bringing an outsourced activity back in-house. Nevertheless, authorities not only expect the number of companies engaging in outsourcing to increase, they also expect companies to outsource an increasing number of functions, especially those in customer service, bookkeeping, financial/clerical, sales/telemarketing, and the mailroom.[56] It is estimated that 50% of U.S. manufacturing will be outsourced to firms in 28 developing countries by 2015.[57]

Offshoring is the outsourcing of an activity or a function to a wholly owned company or an independent provider in another country. Offshoring is a global phenomenon that has been supported by advances in information and communication technologies, the development of stable, secure, and high-speed data transmission systems, and logistical advances like containerized shipping. According to Bain & Company, 51% of large firms in North America, Europe, and Asia outsource offshore.[58] Although India currently has 70% of the offshoring market, countries such as Brazil, China, Russia, the Phillipines, Malaysia, Hungary, the Czech Republic, and Israel are growing in importance. These countries have low-cost qualified labor and an educated workforce. These are important considerations because more than 93% of offshoring companies do so to reduce costs.[59] For example, Mexican assembly line workers average $3.50 an hour plus benefits compared to $27 an hour plus benefits at a GM or Ford plant in the U.S. Less skilled Mexican workers at auto parts makers earn as little as $1.50 per hour with fewer benefits.[60]

Software programming and customer service, in particular, are being outsourced to India. For example, General Electric's back-office services unit, GE Capital International Services, is one of the oldest and biggest of India's outsourcing companies. From only $26 million in 1999, its annual revenues grew to over $420 million by 2004.[61] As part of this trend, IBM acquired Daksh eServices Ltd., one of India's biggest suppliers of remote business services.[62]

Outsourcing, including offshoring, has significant disadvantages. For example, mounting complaints forced Dell Computer to stop routing corporate customers to a technical support call center in Bangalore, India.[63] GE's introduction of a new washing machine was delayed three weeks because of production problems at a supplier's company to which it had contracted out key work. Some companies have found themselves locked into long-term contracts with outside suppliers that were no longer competitive.[64] Some authorities propose that the cumulative effects of continued outsourcing steadily reduces a firm's ability to learn new skills and to develop new core competencies.[65] One survey of 129 outsourcing firms revealed that half the outsourcing projects undertaken in one year failed to deliver anticipated savings. This is in agreement with a survey by Bain & Company in which 51% of large North American, European, and Asian firms stated that outsourcing (including offshoring) did not meet their expectations.[66] Another survey of software projects, by MIT, found that the median Indian project had 10% more software bugs than did comparable U.S. projects.[67] During 2007–2008, tainted goods made by Chinese manufacturers, ranging from lead paint on toys, contaminated heparin, and melamine-laced milk caused their customers to reevaluate the

manner in which they engaged in offshore outsourcing.[68] The increasing cost of oil was making offshoring less economical. Since 2003, crude oil increased in price from $28 to over $100 a barrel in 2008, causing the cost to ship a standard 40-foot container to triple. By 2008 it cost about $100 to ship a ton of iron from Brazil to China, more than the cost of the mineral itself.[69]

A study of 91 outsourcing efforts conducted by European and North American firms found seven major errors that should be avoided:

1. **Outsourcing activities that should not be outsourced:** Companies failed to keep core activities in-house.
2. **Selecting the wrong vendor:** Vendors were not trustworthy or lacked state-of-the-art processes.
3. **Writing a poor contract:** Companies failed to establish a balance of power in the relationship.
4. **Overlooking personnel issues:** Employees lost commitment to the firm.
5. **Losing control over the outsourced activity:** Qualified managers failed to manage the outsourced activity.[70]
6. **Overlooking the hidden costs of outsourcing:** Transaction costs overwhelmed other savings.
7. **Failing to plan an exit strategy:** Companies failed to build reversibility clauses into the contract.[71]

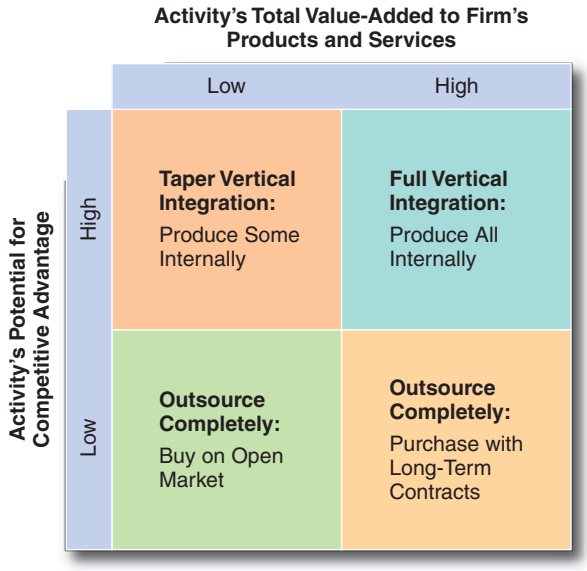
The key to outsourcing is to purchase from outside only those activities that are not key to the company's distinctive competencies. Otherwise, the company may give up the very capabilities that made it successful in the first place—thus putting itself on the road to eventual decline. This is supported by research reporting that companies that have more experience with a particular manufacturing technology tend to keep manufacturing in-house.[72] J. P. Morgan Chase & Company terminated a seven-year technology outsourcing agreement with IBM because the bank's management realized that information technology (IT) was too important strategically to be outsourced.[73]

In determining functional strategy, the strategist must:

- Identify the company's or business unit's core competencies
- Ensure that the competencies are continually being strengthened
- Manage the competencies in such a way that best preserves the competitive advantage they create

An outsourcing decision depends on the fraction of total value added that the activity under consideration represents and on the amount of potential competitive advantage in that activity for the company or business unit. See the outsourcing matrix in **Figure 8–1**. A firm should consider outsourcing any activity or function that has low potential for competitive advantage. If that activity constitutes only a small part of the total value of the firm's products or services, it should be purchased on the open market (assuming that quality providers of the activity are plentiful). If, however, the activity contributes highly to the company's products or services, the firm should purchase it through long-term contracts with trusted suppliers or distributors. A firm should always produce at least some of the activity or function (i.e., taper vertical integration) if that activity has the potential for providing the company some competitive advantage. However, full vertical integration should be considered only when that activity or function adds significant value to the company's products or services in addition to providing competitive advantage.[74]

FIGURE 8–1
Proposed Outsourcing Matrix



SOURCE: *J. D. Hunger and T. L. Wheelen, "Proposed Outsourcing Matrix." Copyright © 1996 and 2005 by Wheelen and Hunger Associates. Reprinted by permission.*

8.3 Strategies to Avoid

Several strategies, that could be considered corporate, business, or functional are very dangerous. Managers who have made poor analyses or lack creativity may be trapped into considering some of the following strategies to avoid:

- **Follow the leader:** Imitating a leading competitor's strategy might seem to be a good idea, but it ignores a firm's particular strengths and weaknesses and the possibility that the leader may be wrong. Fujitsu Ltd., the world's second-largest computer maker, had been driven since the 1960s by the sole ambition of catching up to IBM. Like IBM, Fujitsu competed primarily as a mainframe computer maker. So devoted was it to catching IBM, however, that it failed to notice that the mainframe business had reached maturity by 1990 and was no longer growing.
- **Hit another home run:** If a company is successful because it pioneered an extremely successful product, it tends to search for another super product that will ensure growth and prosperity. As in betting on long shots in horse races, the probability of finding a second winner is slight. Polaroid spent a lot of money developing an "instant" movie camera, but the public ignored it in favor of the camcorder.
- **Arms race:** Entering into a spirited battle with another firm for increased market share might increase sales revenue, but that increase will probably be more than offset by increases in advertising, promotion, R&D, and manufacturing costs. Since the deregulation of airlines, price wars and rate specials have contributed to the low profit margins and bankruptcies of many major airlines, such as Eastern, Pan American, TWA, and United.
- **Do everything:** When faced with several interesting opportunities, management might tend to leap at all of them. At first, a corporation might have enough resources to develop

each idea into a project, but money, time, and energy are soon exhausted as the many projects demand large infusions of resources. The Walt Disney Company's expertise in the entertainment industry led it to acquire the ABC network. As the company churned out new motion pictures and television programs such as *Who Wants to Be a Millionaire*? it spent $750 million to build new theme parks and buy a cruise line and a hockey team. By 2000, even though corporate sales had continued to increase, net income was falling.[75]

- **Losing hand:** A corporation might have invested so much in a particular strategy that top management is unwilling to accept its failure. Believing that it has too much invested to quit, management may continue to throw "good money after bad." Pan American Airlines, for example, chose to sell its Pan Am Building and Intercontinental Hotels, the most profitable parts of the corporation, to keep its money-losing airline flying. Continuing to suffer losses, the company followed this profit strategy of shedding assets for cash until it had sold off everything and went bankrupt.

8.4 Strategic Choice: Selecting the Best Strategy

After the pros and cons of the potential strategic alternatives have been identified and evaluated, one must be selected for implementation. By now, it is likely that many feasible alternatives will have emerged. How is the best strategy determined?

Perhaps the most important criterion is the capability of the proposed strategy to deal with the specific strategic factors developed earlier, in the SWOT analysis. If the alternative doesn't take advantage of environmental opportunities and corporate strengths/competencies, and lead away from environmental threats and corporate weaknesses, it will probably fail.

Another important consideration in the selection of a strategy is the ability of each alternative to satisfy agreed-on objectives with the least resources and the fewest negative side effects. It is, therefore, important to develop a tentative implementation plan in order to address the difficulties that management is likely to face. This should be done in light of societal trends, the industry, and the company's situation based on the construction of scenarios.

CONSTRUCTING CORPORATE SCENARIOS

Corporate scenarios are *pro forma* (estimated future) balance sheets and income statements that forecast the effect each alternative strategy and its various programs will likely have on division and corporate return on investment. (Pro forma financial statements are discussed in **Chapter 12**.) In a survey of Fortune 500 firms, 84% reported using computer simulation models in strategic planning. Most of these were simply spreadsheet-based simulation models dealing with what-if questions.[76]

The recommended scenarios are simply extensions of the industry scenarios discussed in **Chapter 4**. If, for example, industry scenarios suggest the probable emergence of a strong market demand in a specific country for certain products, a series of alternative strategy scenarios can be developed. The alternative of acquiring another firm having these products in that country can be compared with the alternative of a green-field development (e.g., building new operations in that country). Using three sets of estimated sales figures (Optimistic, Pessimistic, and Most Likely) for the new products over the next five years, the two alternatives can be evaluated in terms of their effect on future company performance as reflected in the company's probable future financial statements. Pro forma balance sheets and income statements can be generated with spreadsheet software, such as Excel, on a personal computer. Pro forma statements are based on financial and economic scenarios.

To construct a corporate scenario, follow these steps:

1. Use industry scenarios (as discussed in **Chapter 4**) to develop a set of assumptions about the task environment (in the specific country under consideration). For example, 3M requires the general manager of each business unit to describe annually what his or her industry will look like in 15 years. List *optimistic, pessimistic*, and *most likely* assumptions for key economic factors such as the GDP (Gross Domestic Product), CPI (Consumer Price Index), and prime interest rate and for other key external strategic factors such as governmental regulation and industry trends. This should be done for every country/region in which the corporation has significant operations that will be affected by each strategic alternative. These same underlying assumptions should be listed for each of the alternative scenarios to be developed.
2. Develop common-size financial statements (as discussed in **Chapter 12**) for the company's or business unit's previous years, to serve as the basis for the trend analysis projections of pro forma financial statements. Use the *Scenario Box* form shown in **Table 8–2**:
   a. Use the historical common-size percentages to estimate the level of revenues, expenses, and other categories in estimated pro forma statements for future years.
   b. Develop for each strategic alternative a set of *Optimistic(O)*, *Pessimistic(P)*, and *Most Likely(ML)* assumptions about the impact of key variables on the company's future financial statements.
   c. Forecast three sets of sales and cost of goods sold figures for at least five years into the future.
   d. Analyze historical data and make adjustments based on the environmental assumptions listed earlier. Do the same for other figures that can vary significantly.

TABLE 8–2 Scenario Box for Use in Generating Financial Pro Forma Statements

Factor	Last Year	Historical Average	Trend Analysis	Projections[1]									Comments
				200–			200–			200–			
				O	P	ML	O	P	ML	O	P	ML	
GDP													
CPI													
Other													
Sales units													
Dollars													
COGS													
Advertising and marketing													
Interest expense													
Plant expansion													
Dividends													
Net profits													
EPS													
ROI													
ROE													
Other													

NOTE 1: **O** = Optimistic; **P** = Pessimistic; **ML** = Most Likely.

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e. Assume for other figures that they will continue in their historical relationship to sales or some other key determining factor. Plug in expected inventory levels, accounts receivable, accounts payable, R&D expenses, advertising and promotion expenses, capital expenditures, and debt payments (assuming that debt is used to finance the strategy), among others.
f. Consider not only historical trends but also programs that might be needed to implement each alternative strategy (such as building a new manufacturing facility or expanding the sales force).

3. Construct detailed pro forma financial statements for each strategic alternative:
   a. List the actual figures from this year's financial statements in the left column of the spreadsheet.
   b. List to the right of this column the optimistic figures for years 1 through 5.
   c. Go through this same process with the same strategic alternative, but now list the pessimistic figures for the next five years.
   d. Do the same with the most likely figures.
   e. Develop a similar set of *optimistic* (O), *pessimistic* (P), and *most likely* (ML) pro forma statements for the second strategic alternative. This process generates six different pro forma scenarios reflecting three different situations (O, P, and ML) for two strategic alternatives.
   f. Calculate financial ratios and common-size income statements, and create balance sheets to accompany the pro forma statements.
   g. Compare the assumptions underlying the scenarios with the financial statements and ratios to determine the feasibility of the scenarios. For example, if cost of goods sold drops from 70% to 50% of total sales revenue in the pro forma income statements, this drop should result from a change in the production process or a shift to cheaper raw materials or labor costs rather than from a failure to keep the cost of goods sold in its usual percentage relationship to sales revenue when the predicted statement was developed.

The result of this detailed scenario construction should be anticipated net profits, cash flow, and net working capital for each of three versions of the two alternatives for five years into the future. A strategist might want to go further into the future if the strategy is expected to have a major impact on the company's financial statements beyond five years. The result of this work should provide sufficient information on which forecasts of the likely feasibility and probable profitability of each of the strategic alternatives could be based.

Obviously, these scenarios can quickly become very complicated, especially if three sets of acquisition prices and development costs are calculated. Nevertheless, this sort of detailed what-if analysis is needed to realistically compare the projected outcome of each reasonable alternative strategy and its attendant programs, budgets, and procedures. Regardless of the quantifiable pros and cons of each alternative, the actual decision will probably be influenced by several subjective factors such as those described in the following sections.

Management's Attitude Toward Risk

The attractiveness of a particular strategic alternative is partially a function of the amount of risk it entails. **Risk** is composed not only of the *probability* that the strategy will be effective but also of the *amount of assets* the corporation must allocate to that strategy and the *length of time* the assets will be unavailable for other uses. Because of variation among countries in terms of customs, regulations, and resources, companies operating in global industries must deal with a greater amount of risk than firms operating only in one country.[77] The greater the assets involved and the longer they are committed, the more likely top management is to demand a high probability of success. Managers with no ownership position in a company are unlikely to have

much interest in putting their jobs in danger with risky decisions. Research indicates that managers who own a significant amount of stock in their firms are more likely to engage in risk-taking actions than are managers with no stock.[78]

A high level of risk was why Intel's board of directors found it difficult to vote for a proposal in the early 1990s to commit $5 billion to making the Pentium microprocessor chip—five times the amount of money needed for its previous chip. In looking back on that board meeting, then-CEO Andy Grove remarked, "I remember people's eyes looking at that chart and getting big. I wasn't even sure I believed those numbers at the time." The proposal committed the company to building new factories—something Intel had been reluctant to do. A wrong decision would mean that the company would end up with a killing amount of overcapacity. Based on Grove's presentation, the board decided to take the gamble. Intel's resulting manufacturing expansion eventually cost $10 billion but resulted in Intel's obtaining 75% of the microprocessor business and huge cash profits.[79]

Risk might be one reason that significant innovations occur more often in small firms than in large, established corporations. A small firm managed by an entrepreneur is often willing to accept greater risk than is a large firm of diversified ownership run by professional managers.[80] It is one thing to take a chance if you are the primary shareholder and are not concerned with periodic changes in the value of the company's common stock. It is something else if the corporation's stock is widely held and acquisition-hungry competitors or takeover artists surround the company like sharks every time the company's stock price falls below some external assessment of the firm's value.

A new approach to evaluating alternatives under conditions of high environmental uncertainty is to use real-options theory. According to the **real-options** approach, when the future is highly uncertain, it pays to have a broad range of options open. This is in contrast to using *net present value (NPV)* to calculate the value of a project by predicting its payouts, adjusting them for risk, and subtracting the amount invested. By boiling everything down to one scenario, NPV doesn't provide any flexibility in case circumstances change. NPV is also difficult to apply to projects in which the potential payoffs are currently unknown. The real-options approach, however, deals with these issues by breaking the investment into stages. Management allocates a small amount of funding to initiate multiple projects, monitors their development, and then cancels the projects that aren't successful and funds those that are doing well.[81] This approach is very similar to the way venture capitalists fund an entrepreneurial venture in stages of funding based on the venture's performance.

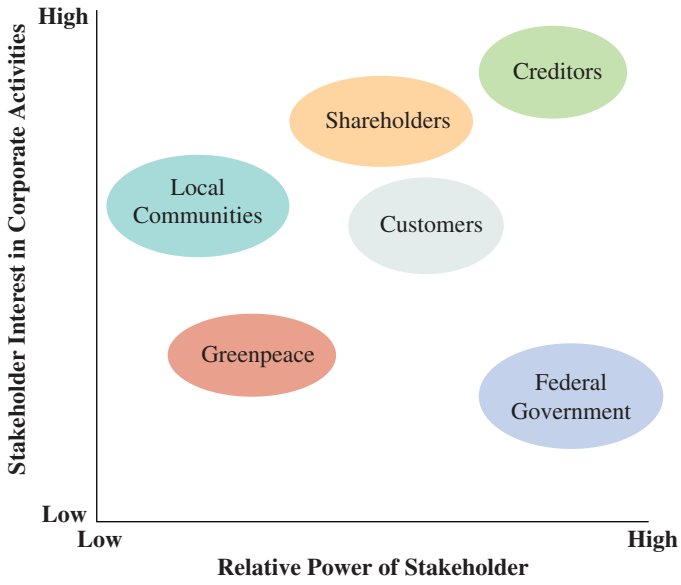
A survey of 4,000 CFOs found that 27% of them always or almost always used some sort of options approach to evaluating and deciding upon growth opportunities.[82] Research indicates that the use of the real-options approach does improve organizational performance.[83] Some of the corporations using the real-options approach are Chevron for bidding on petroleum reserves, Airbus for calculating the costs of airlines changing their orders at the last minute, and the Tennessee Valley Authority for outsourcing electricity generation instead of building its own plant. Because of its complexity, the real-options approach is not worthwhile for minor decisions or for projects requiring a full commitment at the beginning.[84]

Pressures from Stakeholders

The attractiveness of a strategic alternative is affected by its perceived compatibility with the key stakeholders in a corporation's task environment. Creditors want to be paid on time. Unions exert pressure for comparable wage and employment security. Governments and interest groups demand social responsibility. Shareholders want dividends. All these pressures must be given some consideration in the selection of the best alternative.

Stakeholders can be categorized in terms of their (1) interest in the corporation's activities and (2) relative power to influence the corporation's activities. As shown in Figure 8–2, each stakeholder group can be shown graphically based on its *level of interest* (from low to high) in a corporation's activities and on its *relative power* (from low to high) to influence a corporation's activities.

FIGURE 8–2
Stakeholder Priority Matrix



SOURCE: Based on C. Anderson, "Values-Based Management," *Academy of Management Executive* (November 1997), pp. 25–46.

Strategic managers should ask four questions to assess the importance of stakeholder concerns in a particular decision:

1. How will this decision affect each stakeholder, especially those given high and medium priority?
2. How much of what each stakeholder wants is he or she likely to get under this alternative?
3. What are the stakeholders likely to do if they don't get what they want?
4. What is the probability that they will do it?

Strategy makers should choose strategic alternatives that minimize external pressures and maximize the probability of gaining stakeholder support. Managers may, however, ignore or take some stakeholders for granted—leading to serious problems later. The Tata Group, for example, failed to consider the unwillingness of farmers in Singur, India, to accept the West Bengal government's compensation for expropriating their land so that Tata could build its Nano auto plant. Farmers formed rallies against the plant, blocked roads, and even assaulted an employee of a Tata supplier.[86]

Top management can also propose a political strategy to influence its key stakeholders. A **political strategy** is a plan to bring stakeholders into agreement with a corporation's actions. Some of the most commonly used political strategies are constituency building, political action committee contributions, advocacy advertising, lobbying, and coalition building. Research reveals that large firms, those operating in concentrated industries, and firms that are highly dependent upon government regulation are more politically active.[87] Political support can be critical in entering a new international market, especially in transition economies where free market competition did not previously exist.[88]

Pressures from the Corporate Culture

If a strategy is incompatible with a company's corporate culture, the likelihood of its success is very low. Foot-dragging and even sabotage will result as employees fight to resist a radical

change in corporate philosophy. Precedents from the past tend to restrict the kinds of objectives and strategies that are seriously considered.[89] The "aura" of the founders of a corporation can linger long past their lifetimes because their values are imprinted on a corporation's members.

In evaluating a strategic alternative, strategy makers must consider pressures from the corporate culture and assess a strategy's compatibility with that culture. If there is little fit, management must decide if it should:

- Take a chance on ignoring the culture
- Manage around the culture and change the implementation plan
- Try to change the culture to fit the strategy
- Change the strategy to fit the culture

Further, a decision to proceed with a particular strategy without a commitment to change the culture or manage around the culture (both very tricky and time consuming) is dangerous. Nevertheless, restricting a corporation to only those strategies that are completely compatible with its culture might eliminate from consideration the most profitable alternatives. (See **Chapter 10** for more information on managing corporate culture.)

Needs and Desires of Key Managers

Even the most attractive alternative might not be selected if it is contrary to the needs and desires of important top managers. Personal characteristics and experience affect a person's assessment of an alternative's attractiveness.[90] For example, one study found that narcissistic (self-absorbed and arrogant) CEOs favor bold actions that attract attention, like many large acquisitions—resulting in either big wins or big losses.[91] A person's ego may be tied to a particular proposal to the extent that all other alternatives are strongly lobbied against. As a result, the person may have unfavorable forecasts altered so that they are more in agreement with the desired alternative.[92] In a study by McKinsey & Company of 2,507 executives from around the world, 36% responded that managers hide, restrict, or misrepresent information at least "somewhat" frequently when submitting capital-investment proposals. In addition, an executive might influence other people in top management to favor a particular alternative so that objections to it are overruled. In the same McKinsey study of global executives, more than 60% of the managers reported that business unit and divisional heads form alliances with peers or lobby someone more senior in the organization at least "somewhat" frequently when resource allocation decisions are being made.[93]

Industry and cultural backgrounds affect strategic choice. For example, executives with strong ties within an industry tend to choose strategies commonly used in that industry. Other executives who have come to the firm from another industry and have strong ties outside the industry tend to choose different strategies from what is being currently used in their industry.[94] Country of origin often affects preferences. For example, Japanese managers prefer a cost-leadership strategy more than do United States managers.[95] Research reveals that executives from Korea, the U.S., Japan, and Germany tend to make different strategic choices in similar situations because they use different decision criteria and weights. For example, Korean executives emphasize industry attractiveness, sales, and market share in their decisions; whereas, U.S. executives emphasize projected demand, discounted cash flow, and ROI.[96]

There is a tendency to maintain the status quo, which means that decision makers continue with existing goals and plans beyond the point when an objective observer would recommend a change in course.[97] Some executives show a self-serving tendency to attribute the firm's problems not to their own poor decisions but to environmental events out of their control, such as government policies or a poor economic climate.[98] For example, a CEO is more likely to divest a poorly performing unit when its poor performance does not incriminate that same CEO who had acquired it.[99] Negative information about a particular course of action to which a person is committed may be ignored because of a desire to appear competent or

because of strongly held values regarding consistency. It may take a crisis or an unlikely event to cause strategic decision makers to seriously consider an alternative they had previously ignored or discounted.[100] For example, it wasn't until the CEO of ConAgra, a multinational food products company, had a heart attack that ConAgra started producing the Healthy Choice line of low-fat, low-cholesterol, low-sodium frozen-food entrees.

PROCESS OF STRATEGIC CHOICE

There is an old story told at General Motors:

> *At a meeting with his key executives, CEO Alfred Sloan proposed a controversial strategic decision. When asked for comments, each executive responded with supportive comments and praise. After announcing that they were all in apparent agreement, Sloan stated that they were not going to proceed with the decision. Either his executives didn't know enough to point out potential downsides of the decision, or they were agreeing to avoid upsetting the boss and disrupting the cohesion of the group. The decision was delayed until a debate could occur over the pros and cons.*[101]

Strategic choice is the evaluation of alternative strategies and selection of the best alternative. According to Paul Nutt, an authority in decision making, half of the decisions made by managers are failures.[102] After analyzing 400 decisions, Nutt found that failure almost always stems from the actions of the decision maker, not from bad luck or situational limitations. In these instances, managers commit one or more key blunders: (1) their desire for speedy actions leads to a rush to judgment, (2) they apply failure-prone decision-making practices such as adopting the claim of an influential stakeholder, and (3) they make poor use of resources by investigating only one or two options. These three blunders cause executives to limit their search for feasible alternatives and look for quick consensus. Only 4% of the 400 managers set an objective and considered several alternatives. The search for innovative options was attempted in only 24% of the decisions studied.[103] Another study of 68 divestiture decisions found a strong tendency for managers to rely heavily on past experience when developing strategic alternatives.[104]

There is mounting evidence that when an organization is facing a dynamic environment, the best strategic decisions are not arrived at through **consensus** when everyone agrees on one alternative. They actually involve a certain amount of heated disagreement, and even conflict.[105] Many diverse opinions are presented, participants trust in one another's abilities and competences, and conflict is task-oriented, not personal.[106] This is certainly the case for firms operating in global industries. Because unmanaged conflict often carries a high emotional cost, authorities in decision making propose that strategic managers use "programmed conflict" to raise different opinions, regardless of the personal feelings of the people involved.[107] Two techniques help strategic managers avoid the consensus trap that Alfred Sloan found:

1. **Devil's advocate:** The idea of the **devil's advocate** originated in the medieval Roman Catholic Church as a way of ensuring that impostors were not canonized as saints. One trusted person was selected to find and present all the reasons why a person should not be canonized. When this process is applied to strategic decision making, a devil's advocate (who may be an individual or a group) is assigned to identify potential pitfalls and problems with a proposed alternative strategy in a formal presentation.
2. **Dialectical inquiry:** The dialectical philosophy, which can be traced back to Plato and Aristotle and more recently to Hegel, involves combining two conflicting views—the thesis and the antithesis—into a synthesis. When applied to strategic decision making, **dialectical inquiry** requires that two proposals using different assumptions be generated for each alternative strategy under consideration. After advocates of each position present and debate the merits of their arguments before key decision makers, either one of the alternatives or a new compromise alternative is selected as the strategy to be implemented.

Research generally supports the conclusion that the devil's advocate and dialectical inquiry methods are equally superior to consensus in decision making, especially when the firm's environment is dynamic. The debate itself, rather than its particular format, appears to improve the quality of decisions by formalizing and legitimizing constructive conflict and by encouraging critical evaluation. Both lead to better assumptions and recommendations and to a higher level of critical thinking among the people involved.[108]

Regardless of the process used to generate strategic alternatives, each resulting alternative must be rigorously evaluated in terms of its ability to meet four criteria:

1. **Mutual Exclusivity:** Doing any one alternative would preclude doing any other.
2. **Success:** It must be feasible and have a good probability of success.
3. **Completeness:** It must take into account all the key strategic issues.
4. **Internal Consistency:** It must make sense on its own as a strategic decision for the entire firm and not contradict key goals, policies, and strategies currently being pursued by the firm or its units.[109]

8.5 Developing Policies

The selection of the best strategic alternative is not the end of strategy formulation. The organization must then engage in developing policies. Policies define the broad guidelines for implementation. Flowing from the selected strategy, policies provide guidance for decision making and actions throughout the organization. They are the principles under which the corporation operates on a day-to-day basis. At General Electric, for example, Chairman Jack Welch initiated the policy that any GE business unit must be Number One or Number Two in whatever market it competes. This policy gave clear guidance to managers throughout the organization. Another example of such a policy is Casey's General Stores' policy that a new service or product line may be added to its stores only when the product or service can be justified in terms of increasing store traffic.

When crafted correctly, an effective policy accomplishes three things:

- It forces trade-offs between competing resource demands.
- It tests the strategic soundness of a particular action.
- It sets clear boundaries within which employees must operate while granting them freedom to experiment within those constraints.[110]

Policies tend to be rather long lived and can even outlast the particular strategy that created them. These general policies—such as "The customer is always right" (Nordstrom) or "Low prices, every day" (Wal-Mart)—can become, in time, part of a corporation's culture. Such policies can make the implementation of specific strategies easier. They can also restrict top management's strategic options in the future. Thus a change in strategy should be followed quickly by a change in policies. Managing policy is one way to manage the corporate culture.

End of Chapter SUMMARY

This chapter completes the part of this book on strategy formulation and sets the stage for strategy implementation. Functional strategies must be formulated to support business and corporate strategies; otherwise, the company will move in multiple directions and eventually pull itself apart. For a functional strategy to have the best chance of success, it should be built on a distinctive competency residing within that functional area. If a corporation does not have a distinctive competency in a particular functional area, that functional area could be a candidate for outsourcing.

When evaluating a strategic alternative, the most important criterion is the ability of the proposed strategy to deal with the specific strategic factors developed earlier, in the SWOT analysis. If the alternative doesn't take advantage of environmental opportunities and corporate strengths/competencies, and lead away from environmental threats and corporate weaknesses, it will probably fail. Developing corporate scenarios and pro forma projections for each alternative are rational aids for strategic decision making. This logical approach fits Mintzberg's planning mode of strategic decision making, as discussed earlier in **Chapter 1**. Nevertheless, some strategic decisions are inherently risky and may be resolved on the basis of one person's "gut feel." This is an aspect of the entrepreneurial mode and may be used in large established corporations as well as in new venture startups. Various management studies have found that executives routinely rely on their intuition to solve complex problems. The effective use of intuition has been found to differentiate successful top executives and board members from lower-level managers and dysfunctional boards.[111] According to Ralph Larsen, Chair and CEO of Johnson & Johnson, "Often there is absolutely no way that you could have the time to thoroughly analyze every one of the options or alternatives available to you. So you have to rely on your business judgment."[112] For managerial intuition to be effective, however, it requires years of experience in problem solving and is founded upon a complete understanding of the details of the business.[113]

For example, when Bob Lutz, President of Chrysler Corporation, was enjoying a fast drive in his Cobra roadster one weekend in 1988, he wondered why Chrysler's cars were so dull. "I felt guilty: there I was, the president of Chrysler, driving this great car that had such a strong Ford association," said Lutz, referring to the original Cobra's Ford V-8 engine. That Monday, Lutz enlisted allies at Chrysler to develop a muscular, outrageous sports car that would turn heads and stop traffic. Others in management argued that the $80 million investment would be better spent elsewhere. The sales force warned that no U.S. auto maker had ever succeeded in selling a $50,000 car. With only his gut instincts to support him, he pushed the project forward with unwavering commitment. The result was the Dodge Viper—a car that single-handedly changed the public's perception of Chrysler. Years later, Lutz had trouble describing exactly how he had made this critical decision. "It was this subconscious, visceral feeling. And it just felt right," explained Lutz.[114]

ECO-BITS

- In the two-day period after joining the U.S. Environmental Protection Agency's voluntary Climate Leader's initiative, which requires members to reduce or offset emissions over the next 5 to 10 years, the average company's stock price dropped 0.9% more than it would have from normal market factors.[115]
- General Motors states that its facilities recycle 89% of the waste they generate and that GM is one of the world's largest industrial users of solar power.[116]

DISCUSSION QUESTIONS

1. Are functional strategies interdependent, or can they be formulated independently of other functions?
2. Why is penetration pricing more likely than skim pricing to raise a company's or a business unit's operating profit in the long run?
3. How does mass customization support a business unit's competitive strategy?
4. When should a corporation or business unit outsource a function or an activity?
5. What is the relationship of policies to strategies?

STRATEGIC PRACTICE EXERCISE

Pierre Omidyar founded a sole proprietorship in September 1995 called Auction Web to allow people to buy and sell goods over the Internet. The new venture was based on the idea of developing a community-driven process, where an organic, evolving, self-organizing web of individual relationships, formed around shared interests, would handle tasks that other companies handle with customer service operations. By May 1996, Omidyar had added Jeff Skoll as a partner and the venture was incorporated as eBay. Two years later, Omidyar asked Meg Whitman to direct corporate strategy to continue the accelerated growth rate of the company. Whitman brought to the company global management and marketing experience and soon became President and CEO. In almost no time, the company became one of the Web's most successful sites, with 233 million registered users. By 2007, the average eBay user spent nearly two hours a month on the site—more than five times the time spent on Amazon.com.[117]

Whitman expanded the company's operations and spent more than $6 billion to acquire companies, such as Internet-phone operation Skype, online payments service PayPal, ticket reseller StubHub, property rental and roommate search firm Rent.com, comparison shopping site Shopping.com, Web site recommender Stumbleupon, and 25% interest in Craigslist. Expansion and diversification provided revenue and profit growth plus stock price appreciation. Although financial analysts wondered how all these businesses would fit together, Whitman argued that she wanted eBay to be everywhere users wanted to be. At developer conferences, company representatives unveiled new services that let buyers shop for and purchase eBay items outside of the core eBay.com site.

By 2008, eBay was in trouble. Its stock price had lost half its value over the past three years. The core auction and retail businesses, which accounted for the majority of revenue, were showing signs of weakness. The number of active users had been flat for three quarters, at 83 million. The number of new products listed on the site had increased only 4% from the previous year. The number of stores selling goods at fixed prices on eBay declined from a year earlier to 532,000. The company had not done a good job of integrating Skype with its main business. Since its acquisition, Skype's service had actually deteriorated.[118] Competition had increased as rival Web sites, particularly Amazon, now provided similar Web services and eroded eBay's competitive advantage.

On January 23, 2008, CEO Whitman announced that John Donahoe would take over as the company's CEO. Donahoe stated that his first priority would be to revitalize eBay's core business, even at the expense of investors. "We need to aggressively change our product, our customer approach, and our business model," announced the new CEO.[119]

1. What is eBay's problem?
2. Which marketing strategy was eBay following: market development or product development? Do you agree with it?
3. What decision-making process should CEO Donahoe utilize to make the decisions necessary to change the company's product, customer approach, and business model?

KEY TERMS

consensus (p. 257)
corporate scenarios (p. 251)
devil's advocate (p. 257)
dialectical inquiry (p. 257)
financial strategy (p. 239)
functional strategy (p. 238)
HRM strategy (p. 246)
information technology strategy (p. 247)
leveraged buyout (p. 240)
logistics strategy (p. 246)
market development (p. 238)
marketing strategy (p. 238)
offshoring (p. 248)
operations strategy (p. 242)
outsourcing (p. 247)
political strategy (p. 255)
product development (p. 238)
purchasing strategy (p. 244)
R&D strategy (p. 241)
real-options (p. 254)
risk (p. 253)
Stakeholder Priority Matrix (p. 255)
strategic choice (p. 257)
technological follower (p. 241)
technological leader (p. 241)

NOTES

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Ending Case for Part Three

KMART AND SEARS: STILL STUCK IN THE MIDDLE?

On January 22, 2002, Kmart Corporation became the largest retailer in U.S. history to seek bankruptcy protection. In Kmart's petition for reorganization under Chapter 11 of the U.S. Bankruptcy Code, Kmart management announced that they would outline a plan for repaying Kmart's creditors, reducing its size, and restructuring its business so that it could leave court protection as a viable competitor in discount mass-market retailing. Emerging from bankruptcy in May 2003, Kmart still lacked a business strategy to succeed in an extremely competitive marketplace.

The U.S. discount department store industry had reached maturity by 2004 and Kmart no longer possessed a clearly-defined position within that industry. Its primary competitors were Wal-Mart, Sears, Target, Kohl's, and J.C. Penney, with secondary competitors in certain categories. Wal-Mart, an extremely efficient retailer, was known for consistently having the lowest costs (reflected in low prices) and the highest sales in the industry. Having started in rural America, Wal-Mart was now actively growing internationally. Sears, with the second-highest annual sales, had a strong position in hard goods, such as home appliances and tools. Around 40% of all major home appliance sales continued to be controlled by Sears. Nevertheless, Sears was struggling with slumping sales as customers turned from Sears mall stores to stand-alone, big-box retailers, such as Lowe's and Home Depot, to buy their hard goods. Target, third in sales but second in profits, behind Wal-Mart, had distinguished itself as a merchandiser of stylish upscale products. Along with Wal-Mart, Target had flourished to such an extent that Dayton-Hudson, its parent company, had changed its corporate name to Target. Kohl's, a relatively new entrant to the industry, operated 420 family-oriented stores in 32 states. J.C. Penney operated more than 1,000 stores in all 50 states. Both Kohl's and J.C. Penney emphasized soft goods, such as clothing and related items.

Kmart was also challenged by "category killers" that competed in only one or a few industry categories, but in greater depth within any category than could any department store. Some of these were Toys "R" Us, Home Depot, Lowe's, and drug stores such as Rite Aid, CVS, Eckerd, and Walgreens.

Kmart had been established in 1962 by its parent company S.S. Kresge as a discount department store offering the most variety of goods at the lowest prices. Unlike Sears, the company chose not to locate in large shopping malls but to establish its discount stores in highly visible corner locations. During the 1960s, '70s, and '80s, Kmart prospered. By 1990, however, when Wal-Mart first surpassed Kmart in annual sales, Kmart's stores had become dated and lost their appeal. Other well-known discount stores, such as Korvette's, Grant's, Woolco, Ames, Bradlees, and Montgomery Ward, had gone out of business as the industry had consolidated and reached maturity. Attempting to avoid this fate, Kmart management updated and enlarged the stores, added name brands, and hired Martha Stewart as its lifestyle consultant. None of these changes improved Kmart's financial situation. By the time it declared bankruptcy, it had lost money in five of the past 10 years.

Out of bankruptcy, Kmart became profitable—primarily by closing or selling (to Sears and Home Depot) around 600 of its retail stores. Management had been unable to invigorate sales in its stores. Declared guilty of insider trading, Martha Stewart went to prison just before the 2004 Christmas season. In a surprise move, Edward Lampert, Kmart's Chairman of the Board and a controlling shareholder of Kmart, initiated the acquisition of Sears by Kmart for $11 billion in November 2004. The new company was to be called Sears Holdings Corporation. Even though management predicted that the combined company's costs could be reduced by $500 million annually within three years through supplier and administrative economies, analysts wondered how these two struggling firms could ever be successful.

By the end of 2007, the stock of Sears Holdings had fallen to 111 from its peak of 195 earlier in the year. Like many retailers, both Sears and Kmart struggled to attract shoppers in an overcrowded industry and a slumping economy. Sears Holdings did, however, have $1.5 billion in cash, a significant advantage during lean times, and more than its rivals J.C. Penney, Kohl's, and Macy's combined. The company's debt load was only 25% of

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the total capital on its balance sheet, compared to 46% for Penney's and 53% for Macy's. It also had significant real estate assets on its balance sheet. For example, Sears owned outright 518 of its 816 locations and many of the Kmart stores were located in strip malls close to large cities. Since fewer shopping malls were now being built, it was becoming harder to find space for "big-box" retailers in metropolitan areas.

The most recent quarterly results for 2007 of Sears Holdings reported the third straight quarter of deteriorating profit margins and same-store sales. After months of cutting the number of employees and reducing other expenses, industry analysts felt that there was little left to cut. They were also concerned that management had failed to invest in store improvements. Sears Holdings had just launched a bid in November 2007 to purchase Restoration Hardware, a home-goods retailer. Even though Restoration Hardware was also facing sluggish sales, it was thought that Sears' management could use the acquisition to create an upscale boutique within its stores.

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PART 4

Strategy

Implementation and Control

CHAPTER 9

strategy implementation: organizing for Action

For nearly five decades, Wal-Mart's "everyday low prices" and low cost position had enabled it to rapidly grow to dominate North America's retailing landscape. By 2006, however, its U.S. division generated only 1.9% growth in its same-store sales. By 2007, Target, Costco, Kroger, Safeway, Walgreens, CVS, and Best Buy were all growing faster than Wal-Mart. At about the same time, Microsoft, whose software had grown to dominate personal computers worldwide, saw its revenue growth slow to just 8% in 2005. The company's stock price had been flat since 2002, an indication that investors no longer perceived Microsoft as a growth company. What had happened to these two successful companies? Was this an isolated phenomenon? What could be done, if anything, to reinvigorate these giants?[1]

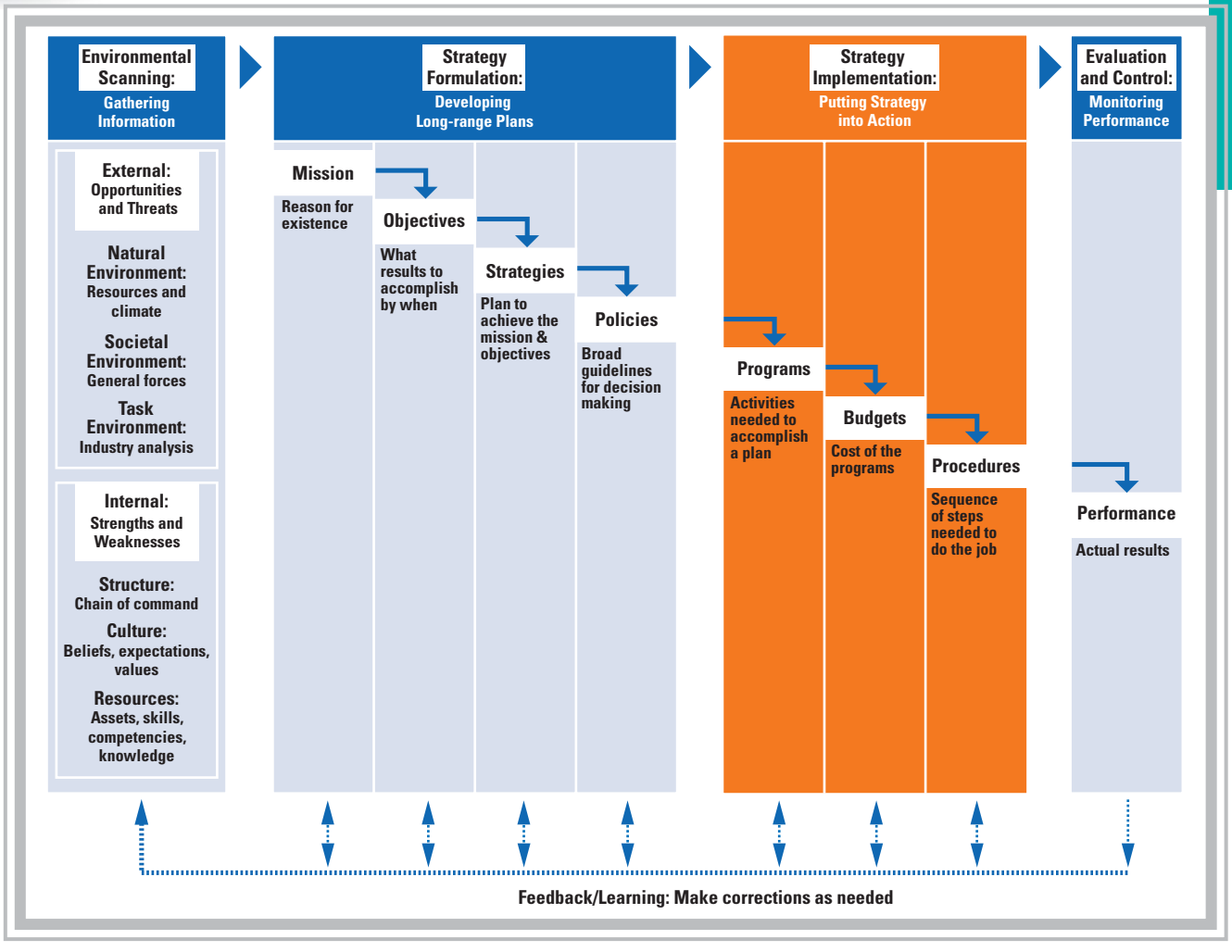
A research study by Matthew Olson, Derek van Bever, and Seth Verry attempts to provide an answer. After analyzing the experiences of 500 successful companies over a 50-year period, they found that 87% of the firms had suffered one or more serious declines in sales and profits. This included a diverse set of corporations, such as Levi Strauss, 3M, Apple, Bank One, Caterpillar, Daimler-Benz, Toys"R"Us, and Volvo. After years of prolonged growth in sales and profits, revenue growth at each of these firms suddenly stopped and even turned negative! Olson, van Bever, and Verry called these long-term reversals in company growth *stall points*. On average, corporations lost 74% of their market capitalization in the decade surrounding a growth stall. Even though the CEO and other members of top management were typically replaced, only 46% of the firms were able to return to moderate or high growth within the decade. When slow growth was allowed to persist for more than 10 years, the delay was usually fatal. Only 7% of this group was able to return to moderate or high growth.[2]

At Levi Strauss & Company, for example, sales topped $7 billion in 1996—extending growth that had more than doubled over the previous decade. From that high-water mark, sales plummeted until they reached $4.6 in 2000—a 35% decline. Market share in its U.S. jeans market dropped from 31% in 1990 to 14% by 2000. Its market value fell from $14 billion to $8 billion during these four years. After replacing management, the company underwent a companywide transformation, but by 2008 it had yet to return to growth.

Learning Objectives

After reading this chapter, you should be able to:

- Develop programs, budgets, and procedures to implement strategic change
- Understand the importance of achieving synergy during strategy implementation
- List the stages of corporate development and the structure that characterizes each stage
- Identify the blocks to changing from one stage to another
- Construct matrix and network structures to support flexible and nimble organizational strategies
- Decide when and if programs such as reengineering, Six Sigma, and job redesign are appropriate methods of strategy implementation
- Understand the centralization versus decentralization issue in multinational corporations



According to Olson, van Bever, and Verry, these stall points occurred primarily because of a poor choice in strategy or organizational design. The root causes fell into four categories:

1. **Premium position backfires:** This happens to a firm that has developed a premium position in the market, but is unable to respond effectively to new, low-cost competitors or a shift in customer valuation of product features. Management teams go through a process of disdain, denial, and rationalization that precedes the fall.
2. **Innovation management breaks down:** Management processes for updating existing products and creating new ones falter and become systemic inefficiencies.
3. **Core business abandoned:** Management fails to exploit growth opportunities in existing core businesses and instead engages in growth initiatives in areas remote from existing customers, products, and distribution channels.
4. **Talent and capabilities run short:** Strategies are not executed properly because of a lack of managers and staff with the skills and capabilities needed for strategy implementation. Often supported by promote-from-within policies, top management has a narrow experience base, which too often replicates the skill set of past top managers.[3]

9.1 Strategy Implementation

Strategy implementation is the sum total of the activities and choices required for the execution of a strategic plan. It is the process by which objectives, strategies, and policies are put into action through the development of programs, budgets, and procedures. Although implementation is usually considered after strategy has been formulated, implementation is a key part of strategic management. Strategy formulation and strategy implementation should thus be considered as two sides of the same coin.

Poor implementation has been blamed for a number of strategic failures. For example, studies show that half of all acquisitions fail to achieve what was expected of them, and one out of four international ventures does not succeed.[4] The most-mentioned problems reported in post-merger integration were poor communication, unrealistic synergy expectations, structural problems, missing master plan, lost momentum, lack of top management commitment, and unclear strategic fit. A study by A. T. Kearney found that a company has just two years in which to make an acquisition perform. After the second year, the window of opportunity for forging synergies has mostly closed. Kearney's study was supported by further independent research by Bert, MacDonald, and Herd. Among the most successful acquirers studied, 70% to 85% of all merger synergies were realized within the first 12 months, with the remainder being realized in year two.[5]

To begin the implementation process, strategy makers must consider these questions:

- *Who* are the people who will carry out the strategic plan?
- *What* must be done to align the company's operations in the new intended direction?
- *How* is everyone going to work together to do what is needed?

These questions and similar ones should have been addressed initially when the pros and cons of strategic alternatives were analyzed. They must also be addressed again before appropriate implementation plans can be made. Unless top management can answer these basic questions satisfactorily, even the best planned strategy is unlikely to provide the desired outcome.

A survey of 93 Fortune 500 firms revealed that more than half of the corporations experienced the following 10 problems when they attempted to implement a strategic change. These problems are listed in order of frequency:

1. Implementation took more time than originally planned.
2. Unanticipated major problems arose.
3. Activities were ineffectively coordinated.
4. Competing activities and crises took attention away from implementation.
5. The involved employees had insufficient capabilities to perform their jobs.
6. Lower-level employees were inadequately trained.
7. Uncontrollable external environmental factors created problems.
8. Departmental managers provided inadequate leadership and direction.
9. Key implementation tasks and activities were poorly defined.
10. The information system inadequately monitored activities.[6]

9.2 Who Implements Strategy?

Depending on how a corporation is organized, those who implement strategy will probably be a much more diverse set of people than those who formulate it. In most large, multi-industry corporations, the implementers are everyone in the organization. Vice presidents of functional areas and directors of divisions or strategic business units (SBUs) work with their subordinates to put together large-scale implementation plans. Plant managers, project managers, and unit heads put together plans for their specific plants, departments, and units. Therefore, every operational manager down to the first-line supervisor and every employee is involved in some way in the implementation of corporate, business, and functional strategies.

Many of the people in the organization who are crucial to successful strategy implementation probably had little to do with the development of the corporate and even business strategy. Therefore, they might be entirely ignorant of the vast amount of data and work that went into the formulation process. Unless changes in mission, objectives, strategies, and policies and their importance to the company are communicated clearly to all operational managers, there can be a lot of resistance and foot-dragging. Managers might hope to influence top management into abandoning its new plans and returning to its old ways. This is one reason why involving people from all organizational levels in the formulation and implementation of strategy tends to result in better organizational performance.[7]

9.3 What Must Be Done?

The managers of divisions and functional areas work with their fellow managers to develop programs, budgets, and procedures for the implementation of strategy. They also work to achieve synergy among the divisions and functional areas in order to establish and maintain a company's distinctive competence.

DEVELOPING PROGRAMS, BUDGETS, AND PROCEDURES

Strategy implementation involves establishing programs to create a series of new organizational activities, budgets to allocate funds to the new activities, and procedures to handle the day-to-day details.

Programs

The purpose of a **program** is to make a strategy action oriented. For example, when Xerox Corporation undertook a turnaround strategy, it needed to significantly reduce its costs and expenses. Management introduced a program called *Lean Six Sigma*. This program was developed to identify and improve a poorly performing process. Xerox first trained its top executives in the program and then launched around 250 individual Six Sigma projects throughout the corporation. The result was $6 million in savings in one year, with even more expected the next.[8] (Six Sigma is explained later in this chapter.)

Most corporate headquarters have around 10 to 30 programs in effect at any one time.[9] One of the programs initiated by Ford Motor Company was to find an organic substitute for petroleum-based foam being used in vehicle seats. For more information on Ford's innovative soybean seat program, see the **Environment Sustainability Issue** feature.

One way to examine the likely impact new programs will have on an existing organization is to compare proposed programs and activities with current programs and activities. Brynjolfsson, Renshaw, and Van Alstyne proposed a **matrix of change** to help managers decide how quickly change should proceed, in what order changes should take place, whether to start at a new site, and whether the proposed systems are stable and coherent. As shown in **Figure 9–1**, target practices (new programs) for a manufacturing plant are drawn on the

ENVIRONMENTAL sustainability issue

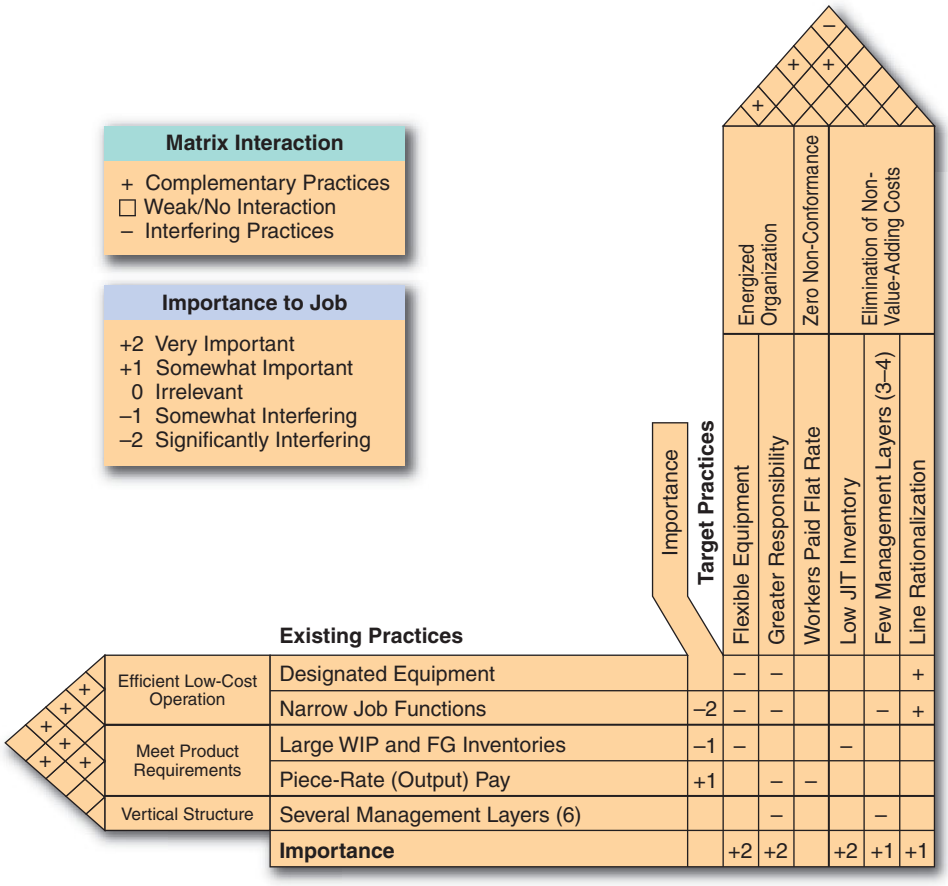
FORD'S SOYBEAN SEAT FOAM PROGRAM

The Model T Ford once contained 60 pounds of soybeans in its paint and molded plastic parts. Since that time, petroleum has become the primary ingredient in most plastic parts, including the foam currently used in car and truck seats. Nevertheless, today's manufacturers are looking for ways to replace petroleum-based products with ones made from agricultural crops, as the political, environmental, and economic costs of oil increase. According to Larry Johnson, Director of the Center for Crops Utilization Research at Iowa State University, soy is usually cheaper and more environmentally friendly than petroleum and comes from a renewable agricultural source. With this in mind, Ford's management initiated a program in 2001 with seat supplier Lear Corporation to research soy-based foam as a possible substitute for petroleum-based foam. The program was a huge success. A complete seating system, including suspension systems, contains about 20% soy oil. The new seats were used in the Mustang and other Ford vehicles delivered to auto showrooms beginning August 2007.

Sears Manufacturing Company, a seat supplier to Deere and other companies, licensed the Ford technology to work with Deere in developing soy-based foam for seats on Deere's farm and construction equipment. Deere was already using soy-based materials for parts such as hoods, side panels, and doors on some models of tractors, combines, cotton pickers, and backhoes. According to John Koutsky, Vice President of Product Development, Sears started commercial production of the new seats in 2009 and planned to use soy foam throughout its product line being sold to heavy truck manufacturers like Freightliner and International. "It's good to be green," commented Koutsky.

SOURCE: "Manufacturers Turn to Soy for Cushy Seats," *St. Cloud* (MN) *Times* (January 26, 2008), p. 3A, and Ford Motor Company Web site (www.Ford.com).

FIGURE 9–1
The Matrix of Change



SOURCE: Reprinted from The Matrix of Change by E. Brynjolfsson, A.A. Renshaw, and M. Van Alstyne. *Sloan Management Review,* Winter 1997, pp. 168-181. From MIT Sloan Management Review © 1997 by Massachusetts Institute of Technology. All rights reserved. Distributed by Tribune Media Services.

vertical axis and existing practices (current activities) are drawn on the horizontal axis. As shown, any new strategy will likely involve a sequence of new programs and activities. Any one of these may conflict with existing practices/activities—and that creates implementation problems. Use the following steps to create the matrix:

1. Compare the new programs/target practices with each other to see if they are complementary (+), interfering (−), or have no effect on each other (leave blank).
2. Examine existing practices/activities for their interactions with each other using the same symbols as in step 1.
3. Compare each new program/target practice with each existing practice/activity for any interaction effects. Place the appropriate symbols in the cells in the lower-right part of the matrix.
4. Evaluate each program/activity in terms of its relative importance to achieving the strategy or getting the job accomplished.
5. Examine the overall matrix to identify problem areas where proposed programs are likely to either interfere with each other or with existing practices/activities. Note in **Figure 9–1** that the proposed program of installing flexible equipment interferes with the proposed

program of assembly line rationalization. The two new programs need to be changed so that they no longer conflict with each other. Note also that the amount of change necessary to carry out the proposed implementation programs (target practices) is a function of the number of times each program interferes with existing practices/activities. That is, the more minus signs and the fewer plus signs in the matrix, the more implementation problems can be expected.

The matrix of change can be used to address the following types of questions:

- **Feasibility:** Do the proposed programs and activities constitute a coherent, stable system? Are the current activities coherent and stable? Is the transition likely to be difficult?
- **Sequence of execution:** Where should the change begin? How does the sequence affect success? Are there reasonable stopping points?
- **Location:** Are we better off instituting the new programs at a new site, or can we reorganize the existing facilities at a reasonable cost?
- **Pace and nature of change:** Should the change be slow or fast, incremental or radical? Which blocks of current activities must be changed at the same time?
- **Stakeholder evaluations:** Have we overlooked any important activities or interactions? Should we get further input from interested stakeholders? Which new programs and current activities offer the greatest sources of value?

The matrix offers useful guidelines on where, when, and how fast to implement change.[10]

Budgets

After programs have been developed, the **budget** process begins. Planning a budget is the last real check a corporation has on the feasibility of its selected strategy. An ideal strategy might be found to be completely impractical only after specific implementation programs are costed in detail. As an example, once Cadbury Schweppes' management realized how dependent the company was on cocoa from Ghana to continue the company's growth strategy, it developed a program to show cocoa farmers how to increase yields using fertilizers and by working with each other. Ghana produced 70% of Cadbury's worldwide supply of the high-quality cocoa necessary to provide the distinctive taste of Dairy Milk, Crème Egg, and other treats. Management introduced the "Cadbury Cocoa Partnership" on January 28, 2008, and budgeted $87 million for this program over a 10-year period.[11]

Procedures

After the program, divisional, and corporate budgets are approved, **procedures** must be developed. Often called *Standard Operating Procedures (SOPs),* they typically detail the various activities that must be carried out to complete a corporation's programs. Also known as *organizational routines*, procedures are the primary means by which organizations accomplish much of what they do.[12] Once in place, procedures must be updated to reflect any changes in technology as well as in strategy. For example, a company following a differentiation competitive strategy manages its sales force more closely than does a firm following a low-cost strategy. Differentiation requires long-term customer relationships created out of close interaction with the sales force. An in-depth understanding of the customer's needs provides the foundation for product development and improvement.[13]

In a retail store, procedures ensure that the day-to-day store operations will be consistent over time (that is, next week's work activities will be the same as this week's) and consistent among stores (that is, each store will operate in the same manner as the others). Properly planned procedures can help eliminate poor service by making sure that employees do use not

excuses to justify poor behavior toward customers. Even though McDonald's, the fast-food restaurant, has developed very detailed procedures to ensure that customers have high quality service, not every business is so well managed. See **Strategy Highlight 9.1** for the top 10 excuses for bad service.

Before a new strategy can be successfully implemented, current procedures may need to be changed. For example, in order to implement Home Depot's strategic move into services, such as kitchen and bathroom installation, the company had to first improve its productivity. Store managers were drowning in paperwork designed for a smaller and simpler company. "We'd get a fax, an e-mail, a call, and a memo, all on the same project," reported store manager Michael Jones. One executive used just three weeks of memos to wallpaper an entire conference room, floor to ceiling, windows included. CEO Robert Nardelli told his top managers

STRATEGY highlight 9.1

THE TOP TEN EXCUSES FOR BAD SERVICE

Corporations may have official policies stating that the "customer is always right" or "customer is number one," but these quickly become meaningless platitudes unless procedures are developed and communicated to all employees for them to follow when confronted with a problem or a question from a customer. Beware of the top ten excuses for bad service. They can sabotage a company's strategy and send valued customers to the competition. How many times have you heard the following excuses when you received poor service? Or even worse, how many times have you personally given one or all of these excuses?

#10. **Customer complaint:** Why do I have to wait so long for service? **Excuse:** To get service as good as ours, sometimes you have to wait; our guests expect that.

#9. **Customer complaint:** Why didn't your service meet what I expected? **Excuse:** Nobody's perfect; we simply can't make every customer happy.

#8. **Customer complaint:** Why didn't you let us have it "our way"? **Excuse:** We're sorry, but if we did it "your way" for all our customers, we would crash our systems and overextend our already overworked employees.

#7. **Customer complaint:** Service wasn't as good this time as it was the last time we were here. **Excuse:** Everybody has good days and bad days; we're doing our best to please you, but we can't always be perfect.

#6. **Customer complaint:** Your place is dirty, dated, and worn. **Excuse:** We do our best to keep it clean and up to date, but we can't afford to follow every customer around to make sure we pick up everything, nor can we refurbish our place all the time.

#5. **Customer complaint:** I placed my order a while ago, why is it taking so long? **Excuse:** Sorry, but we are very busy right now. You came at our "busy" time and you must be patient.

#4. **Customer complaint:** Your server did not seem to know what he/she was doing and made a mess of my experience. **Excuse:** Unfortunately, with all the turnover we are having right now, we just didn't have the time to train everyone up to our standards.

#3. **Customer complaint:** Your employee was rude to me and has a bad attitude. **Excuse:** We do apologize for the unfortunate attitude of a few employees.

#2. **Customer complaint:** The server didn't seem to be interested in doing what he/she was supposed to do. Why can't she/he do it the right way? **Excuse:** We are sorry. While we trained them to do it the right way, sometimes they just seem to ignore what we taught them.

#1. **Customer complaint:** We expected something different from your company and we are really disappointed. **Excuse:** You must be misinformed, as we have been successful for a long time and obviously know exactly what our customers want and need.

SOURCE: D. Dickson, R. C. Ford, and B. Laval, "The Top Ten Excuses for Bad Service (and How to Avoid Needing Them)" *Organizational Dynamics*, Vol. 34, Issue 2 (2005), pp. 168–181.

to eliminate duplicate communications and streamline work projects. Directives not related to work orders had to be sent separately and only once a month. The company also spent $2 million on workload-management software.[14]

ACHIEVING SYNERGY

One of the goals to be achieved in strategy implementation is synergy between and among functions and business units. This is the reason corporations commonly reorganize after an acquisition. **Synergy** is said to exist for a divisional corporation if the return on investment (ROI) of each division is greater than what the return would be if each division were an independent business. According to Goold and Campbell, synergy can take place in one of six forms:

- **Shared know-how:** Combined units often benefit from sharing knowledge or skills. This is a leveraging of core competencies. One reason that Procter & Gamble purchased Gillette was to combine P&G's knowledge of the female consumer with Gillette's knowledge of the male consumer.
- **Coordinated strategies:** Aligning the business strategies of two or more business units may provide a corporation significant advantage by reducing inter-unit competition and developing a coordinated response to common competitors (horizontal strategy). The merger between Arcelor and Mittal Steel, for example, gave the combined company enhanced R&D capabilities and wider global coverage while presenting a common face to the market.
- **Shared tangible resources:** Combined units can sometimes save money by sharing resources, such as a common manufacturing facility or R&D lab. The alliance between Renault and Nissan allowed it to build new factories that would build both Nissan and Renault vehicles.
- **Economies of scale or scope:** Coordinating the flow of products or services of one unit with that of another unit can reduce inventory, increase capacity utilization, and improve market access. This was a reason Delta Airlines bought Northwest Airlines.
- **Pooled negotiating power:** Combined units can combine their purchasing to gain bargaining power over common suppliers to reduce costs and improve quality. The same can be done with common distributors. The acquisitions of Macy's and the May Company enabled Federated Department Stores (which changed its name to Macy's in 2007) to gain purchasing economies for all of its stores.
- **New business creation:** Exchanging knowledge and skills can facilitate new products or services by extracting discrete activities from various units and combining them in a new unit or by establishing joint ventures among internal business units. Oracle, for example, purchased a number of software companies in order to create a suite of software codenamed "Project Fusion" to help corporations run everything from accounting and sales to customer relations and supply-chain management.[15]

9.4 How Is Strategy to Be Implemented? Organizing for Action

Before plans can lead to actual performance, a corporation should be appropriately organized, programs should be adequately staffed, and activities should be directed toward achieving desired objectives. (Organizing activities are reviewed briefly in this chapter; staffing, directing, and control activities are discussed in **Chapters 10** and **11**.)

Any change in corporate strategy is very likely to require some sort of change in the way an organization is structured and in the kind of skills needed in particular positions. Managers must, therefore, closely examine the way their company is structured in order to decide what, if any, changes should be made in the way work is accomplished. Should activities be grouped differently? Should the authority to make key decisions be centralized at headquarters or decentralized to managers in distant locations? Should the company be managed like a "tight ship" with many rules and controls, or "loosely" with few rules and controls? Should the corporation be organized into a "tall" structure with many layers of managers, each having a narrow span of control (that is, few employees per supervisor) to better control his or her subordinates; or should it be organized into a "flat" structure with fewer layers of managers, each having a wide span of control (that is, more employees per supervisor) to give more freedom to his or her subordinates?

STRUCTURE FOLLOWS STRATEGY

In a classic study of large U.S. corporations such as DuPont, General Motors, Sears, and Standard Oil, Alfred Chandler concluded that **structure follows strategy**—that is, changes in corporate strategy lead to changes in organizational structure.[16] He also concluded that organizations follow a pattern of development from one kind of structural arrangement to another as they expand. According to Chandler, these structural changes occur because the old structure, having been pushed too far, has caused inefficiencies that have become too obviously detrimental to bear. Chandler, therefore, proposed the following as the sequence of what occurs:

1. New strategy is created.
2. New administrative problems emerge.
3. Economic performance declines.
4. New appropriate structure is invented.
5. Profit returns to its previous level.

Chandler found that in their early years, corporations such as DuPont tend to have a centralized functional organizational structure that is well suited to producing and selling a limited range of products. As they add new product lines, purchase their own sources of supply, and create their own distribution networks, they become too complex for highly centralized structures. To remain successful, this type of organization needs to shift to a decentralized structure with several semiautonomous divisions (referred to in **Chapter 5** as *divisional structure*).

Alfred P. Sloan, past CEO of General Motors, detailed how GM conducted such structural changes in the 1920s.[17] He saw decentralization of structure as "centralized policy determination coupled with decentralized operating management." After top management had developed a strategy for the total corporation, the individual divisions (Chevrolet, Buick, and so on) were free to choose how to implement that strategy. Patterned after DuPont, GM found the decentralized multidivisional structure to be extremely effective in allowing the maximum amount of freedom for product development. Return on investment was used as a financial control. (ROI is discussed in more detail in **Chapter 11**.)

Research generally supports Chandler's proposition that structure follows strategy (as well as the reverse proposition that structure influences strategy).[18] As mentioned earlier, changes in the environment tend to be reflected in changes in a corporation's strategy, thus leading to changes in a corporation's structure. In 2008, Arctic Cat, the recreational vehicles firm, reorganized its ATV (all terrain vehicles), snowmobile and parts, and garments and accessories product

lines into three separate business units, each led by a general manager focused on expanding the business. True to Chandler's findings, the restructuring of Arctic Cat came after seven consecutive years of record growth followed by its first loss in 25 years.

Strategy, structure, and the environment need to be closely aligned; otherwise, organizational performance will likely suffer.[19] For example, a business unit following a differentiation strategy needs more freedom from headquarters to be successful than does another unit following a low-cost strategy.[20]

Although it is agreed that organizational structure must vary with different environmental conditions, which, in turn, affect an organization's strategy, there is no agreement about an optimal organizational design. What was appropriate for DuPont and General Motors in the 1920s might not be appropriate today. Firms in the same industry do, however, tend to organize themselves similarly to one another. For example, automobile manufacturers tend to emulate General Motors' divisional concept, whereas consumer-goods producers tend to emulate the brand-management concept (a type of matrix structure) pioneered by Procter & Gamble Company. The general conclusion seems to be that firms following similar strategies in similar industries tend to adopt similar structures.

STAGES OF CORPORATE DEVELOPMENT

Successful corporations tend to follow a pattern of structural development as they grow and expand. Beginning with the simple structure of the entrepreneurial firm (in which everybody does everything), successful corporations usually get larger and organize along functional lines, with marketing, production, and finance departments. With continuing success, the company adds new product lines in different industries and organizes itself into interconnected divisions. The differences among these three structural **stages of corporate development** in terms of typical problems, objectives, strategies, reward systems, and other characteristics are specified in detail in **Table 9–1.**

Stage I: Simple Structure

Stage I is typified by the entrepreneur, who founds a company to promote an idea (a product or a service). The entrepreneur tends to make all the important decisions personally and is involved in every detail and phase of the organization. The Stage I company has little formal structure, which allows the entrepreneur to directly supervise the activities of every employee (see **Figure 5–4** for an illustration of the simple, functional, and divisional structures). Planning is usually short range or reactive. The typical managerial functions of planning, organizing, directing, staffing, and controlling are usually performed to a very limited degree, if at all. The greatest strengths of a Stage I corporation are its flexibility and dynamism. The drive of the entrepreneur energizes the organization in its struggle for growth. Its greatest weakness is its extreme reliance on the entrepreneur to decide general strategies as well as detailed procedures. If the entrepreneur falters, the company usually flounders. This is labeled by Greiner as a *crisis of leadership*.[21]

Stage I describes Oracle Corporation, the computer software firm, under the management of its co-founder and CEO Lawrence Ellison. The company adopted a pioneering approach to retrieving data, called Structured Query Language (SQL). When IBM made SQL its standard, Oracle's success was assured. Unfortunately, Ellison's technical wizardry was not sufficient to manage the company. Often working at home, he lost sight of details outside his technical interests. Although the company's sales were rapidly increasing, its financial controls were so weak that management had to restate an entire year's results to rectify irregularities. After the company recorded its first loss, Ellison hired a set of functional managers to run the company while he retreated to focus on new product development.

TABLE 9–1 Factors Differentiating Stage I, II, and III Companies

Function	Stage I	Stage II	Stage III
1. Sizing up: Major problems	Survival and growth dealing with short-term operating problems.	Growth, rationalization, and expansion of resources, providing for adequate attention to product problems.	Trusteeship in management and investment and control of large, increasing, and diversified resources. Also, important to diagnose and take action on problems at division level.
2. Objectives	Personal and subjective.	Profits and meeting functionally oriented budgets and performance targets.	ROI, profits, earnings per share.
3. Strategy	Implicit and personal; exploitation of immediate opportunities seen by owner-manager.	Functionally oriented moves restricted to "one product" scope; exploitation of one basic product or service field.	Growth and product diversification; exploitation of general business opportunities.
4. Organization: Major characteristic of structure	One unit, "one-man show."	One unit, functionally specialized group.	Multiunit general staff office and decentralized operating divisions.
5. (a) Measurement and control	Personal, subjective control based on simple accounting system and daily communication and observation.	Control grows beyond one person; assessment of functional operations necessary; structured control systems evolve.	Complex formal system geared to comparative assessment of performance measures, indicating problems and opportunities and assessing management ability of division managers.
5. (b) Key performance indicators	Personal criteria, relationships with owner, operating efficiency, ability to solve operating problems.	Functional and internal criteria such as sales, performance compared to budget, size of empire, status in group, personal, relationships, etc.	More impersonal application of comparisons such as profits, ROI, P/E ratio, sales, market share, productivity, product leadership, personnel development, employee attitudes, public responsibility.
6. Reward-punishment system	Informal, personal, subjective; used to maintain control and divide small pool of resources for key performers to provide personal incentives.	More structured; usually based to a greater extent on agreed policies as opposed to personal opinion and relationships.	Allotment by "due process" of a wide variety of different rewards and punishments on a formal and systematic basis. Companywide policies usually apply to many different classes of managers and workers with few major exceptions for individual cases.

SOURCE: D.H. Thain, "Stages of Corporate Development," *Ivey Business Quarterly,* Winter 1969, p. 37. © 1969 Ivey Management Services. One time Permission to reproduce granted by Ivey Management Services.

Stage II: Functional Structure

Stage II is the point when the entrepreneur is replaced by a team of managers who have functional specializations. The transition to this stage requires a substantial managerial style change for the chief officer of the company, especially if he or she was the Stage I entrepreneur. He or she must learn to delegate; otherwise, having additional staff members yields no benefits to the organization. The previous example of Ellison's retreat from top management

at Oracle Corporation to new product development manager is one way that technically brilliant founders are able to get out of the way of the newly empowered functional managers. In Stage II, the corporate strategy favors protectionism through dominance of the industry, often through vertical and horizontal growth. The great strength of a Stage II corporation lies in its concentration and specialization in one industry. Its great weakness is that all its eggs are in one basket.

By concentrating on one industry while that industry remains attractive, a Stage II company, such as Oracle Corporation in computer software, can be very successful. Once a functionally structured firm diversifies into other products in different industries, however, the advantages of the functional structure break down. A *crisis of autonomy* can now develop, in which people managing diversified product lines need more decision-making freedom than top management is willing to delegate to them. The company needs to move to a different structure.

Stage III: Divisional Structure

Stage III is typified by the corporation's managing diverse product lines in numerous industries; it decentralizes the decision-making authority. Stage III organizations grow by diversifying their product lines and expanding to cover wider geographical areas. They move to a divisional structure with a central headquarters and decentralized operating divisions—with each division or business unit a functionally organized Stage II company. They may also use a conglomerate structure if top management chooses to keep its collection of Stage II subsidiaries operating autonomously. A *crisis of control* can now develop, in which the various units act to optimize their own sales and profits without regard to the overall corporation, whose headquarters seems far away and almost irrelevant.

Recently, divisions have been evolving into SBUs to better reflect product-market considerations. Headquarters attempts to coordinate the activities of its operating divisions or SBUs through performance- and results-oriented control and reporting systems and by stressing corporate planning techniques. The units are not tightly controlled but are held responsible for their own performance results. Therefore, to be effective, the company has to have a decentralized decision process. The greatest strength of a Stage III corporation is its almost unlimited resources. Its most significant weakness is that it is usually so large and complex that it tends to become relatively inflexible. General Electric, DuPont, and General Motors are examples of Stage III corporations.

Stage IV: Beyond SBUs

Even with its evolution into SBUs during the 1970s and 1980s, the divisional structure is not the last word in organization structure. The use of SBUs may result in a *red tape crisis* in which the corporation has grown too large and complex to be managed through formal programs and rigid systems, and procedures take precedence over problem solving.[22] For example, Pfizer's acquisitions of Warner-Lambert and Pharmacia resulted in 14 layers of management between scientists and top executives and forced researchers to spend most of their time in meetings.[23] Under conditions of (1) increasing environmental uncertainty, (2) greater use of sophisticated technological production methods and information systems, (3) the increasing size and scope of worldwide business corporations, (4) a greater emphasis on multi-industry competitive strategy, and (5) a more educated cadre of managers and employees, new advanced forms of organizational structure are emerging. These structures emphasize collaboration over competition in the managing of an organization's multiple overlapping projects and developing businesses.

The matrix and the network are two possible candidates for a fourth stage in corporate development—a stage that not only emphasizes horizontal over vertical connections between people and groups but also organizes work around temporary projects in which sophisticated

information systems support collaborative activities. According to Greiner, it is likely that this stage of development will have its own crisis as well—a sort of *pressure-cooker crisis*. He predicts that employees in these collaborative organizations will eventually grow emotionally and physically exhausted from the intensity of teamwork and the heavy pressure for innovative solutions.[24]

Blocks to Changing Stages

Corporations often find themselves in difficulty because they are blocked from moving into the next logical stage of development. Blocks to development may be internal (such as lack of resources, lack of ability, or refusal of top management to delegate decision making to others) or external (such as economic conditions, labor shortages, and lack of market growth). For example, Chandler noted in his study that the successful founder/CEO in one stage was rarely the person who created the new structure to fit the new strategy, and as a result, the transition from one stage to another was often painful. This was true of General Motors Corporation under the management of William Durant, Ford Motor Company under Henry Ford I, Polaroid Corporation under Edwin Land, Apple Computer under Steven Jobs, and Sun Microsystems under Scott McNealy.

Entrepreneurs who start businesses generally have four tendencies that work very well for small new ventures but become Achilles' heels for these same individuals when they try to manage a larger firm with diverse needs, departments, priorities, and constituencies:

- **Loyalty to comrades:** This is good at the beginning but soon becomes a liability as "favoritism."
- **Task oriented:** Focusing on the job is critical at first but then becomes excessive attention to detail.
- **Single-mindedness:** A grand vision is needed to introduce a new product but can become tunnel vision as the company grows into more markets and products.
- **Working in isolation:** This is good for a brilliant scientist but disastrous for a CEO with multiple constituencies.[25]

This difficulty in moving to a new stage is compounded by the founder's tendency to maneuver around the need to delegate by carefully hiring, training, and grooming his or her own team of managers. The team tends to maintain the founder's influence throughout the organization long after the founder is gone. This is what happened at Walt Disney Productions when the family continued to emphasize Walt's policies and plans long after he was dead. Although this may often be an organization's strength, it may also be a weakness—to the extent that the culture supports the status quo and blocks needed change.

ORGANIZATIONAL LIFE CYCLE

Instead of considering stages of development in terms of structure, the organizational life cycle approach places the primary emphasis on the dominant issue facing the corporation. Organizational structure is only a secondary concern. The **organizational life cycle** describes how organizations grow, develop, and eventually decline. It is the organizational equivalent of the product life cycle in marketing. These stages are Birth (Stage I), Growth (Stage II), Maturity (Stage III), Decline (Stage IV), and Death (Stage V). The impact of these stages on corporate strategy and structure is summarized in **Table 9–2.** Note that the first three stages of the organizational life cycle are similar to the three commonly accepted stages of corporate development mentioned previously. The only significant difference is the addition of the Decline and Death stages to complete the cycle. Even though a company's strategy may still be sound, its

TABLE 9–2 Organizational Life Cycle

	Stage I	Stage II	Stage III*	Stage IV	Stage V
Dominant Issue	Birth	Growth	Maturity	Decline	Death
Popular Strategies	Concentration in a niche	Horizontal and vertical growth	Concentric and conglomerate diversification	Profit strategy followed by retrenchment	Liquidation or bankruptcy
Likely Structure	Entrepreneur dominated	Functional management emphasized	Decentralization into profit or investment centers	Structural surgery	Dismemberment of structure

NOTE: *An organization may enter a Revival phase either during the Maturity or Decline stages and thus extend the organization's life.

aging structure, culture, and processes may be such that they prevent the strategy from being executed properly. Its core competencies become *core rigidities* that are no longer able to adapt to changing conditions—thus the company moves into Decline.[26]

Movement from Growth to Maturity to Decline and finally to Death is not, however, inevitable. A Revival phase may occur sometime during the Maturity or Decline stages. The corporation's life cycle can be extended by managerial and product innovations.[27] Developing new combinations of existing resources to introduce new products or acquiring new resources through acquisitions can enable firms with declining performance to regain growth—so long as the action is valuable and difficult to imitate.[28] This can occur during the implementation of a turnaround strategy.[29] Nevertheless, the fact that firms in decline are less likely to search for new technologies suggests that it is difficult to revive a company in decline.[30]

Eastman Kodak is an example of a firm in decline that has been attempting to develop new combinations of its existing resources to introduce new products, and thus, revive the corporation. When Antonio Perez left Hewlett-Packard to become Kodak's President in 2003, Kodak was in the midst of its struggle to make the transition from chemical film technology to digital technology and digital cameras. Instead of focusing the company's efforts on acquisitions to find growth, Perez looked at technologies that Kodak already owned, but was not utilizing. He noticed that Kodak scientists had developed new ink to yield photo prints with vivid colors that would last a lifetime. He suddenly realized that Kodak's distinctive competence was not in digital photography, where other competitors led the market, but in color printing. Perez initiated project *Goza* to go head to head with HP in the consumer inkjet printer business. In 2007, Kodak unveiled its new line of multipurpose machines that not only handled photographs and documents, but also made copies and sent faxes. The printers were designed to print high-quality photos with ink that would stay vibrant for 100 rather than the usual 15 years. Most importantly, replacement ink cartridges would cost half the price of competitors' cartridges. According to Perez, "We think it will give us the opportunity to disrupt the industry's business model and address consumers' key dissatisfaction: the high cost of ink." Perez then predicted that Kodak's inkjet printers would become a multibillion-dollar product line.[31]

Unless a company is able to resolve the critical issues facing it in the Decline stage, it is likely to move into Stage V, Death—also known as bankruptcy. This is what happened to Montgomery Ward, Pan American Airlines, Macy's Department Stores, Baldwin-United, Eastern Airlines, Colt's Manufacturing, Orion Pictures, and Wheeling-Pittsburgh Steel, as well as many other firms. As in the cases of Johns-Manville, International Harvester, Macy's, and Kmart—all of which went bankrupt—a corporation can rise like a phoenix from its own ashes and live again under the same or a different name. The company may be reorganized or liquidated, depending on individual circumstances. For example, Kmart emerged from Chapter 11 bankruptcy in 2003 with a new CEO and a plan to sell a number of its stores to

Home Depot and Sears. These sales earned the company close to $1 billion. Although store sales continued to erode, Kmart had sufficient cash reserves to continue with its turnaround.[32] It used that money to acquire Sears in 2005. Unfortunately, however, fewer than 20% of firms entering Chapter 11 bankruptcy in the United States emerge as going concerns; the rest are forced into liquidation.[33]

Few corporations will move through these five stages in order. Some corporations, for example, might never move past Stage II. Others, such as General Motors, might go directly from Stage I to Stage III. A large number of entrepreneurial ventures jump from Stage I or II directly into Stage IV or V. Hayes Microcomputer Products, for example, went from the Growth to Decline stage under its founder Dennis Hayes. The key is to be able to identify indications that a firm is in the process of changing stages and to make the appropriate strategic and structural adjustments to ensure that corporate performance is maintained or even improved.

ADVANCED TYPES OF ORGANIZATIONAL STRUCTURES

The basic structures (simple, functional, divisional, and conglomerate) are discussed in **Chapter 5** and summarized under the first three stages of corporate development in this chapter. A new strategy may require more flexible characteristics than the traditional functional or divisional structure can offer. Today's business organizations are becoming less centralized with a greater use of cross-functional work teams. **Table 9–3** depicts some of the changing structural characteristics of modern corporations. Although many variations and hybrid structures contain these characteristics, two forms stand out: the matrix structure and the network structure.

Matrix Structure

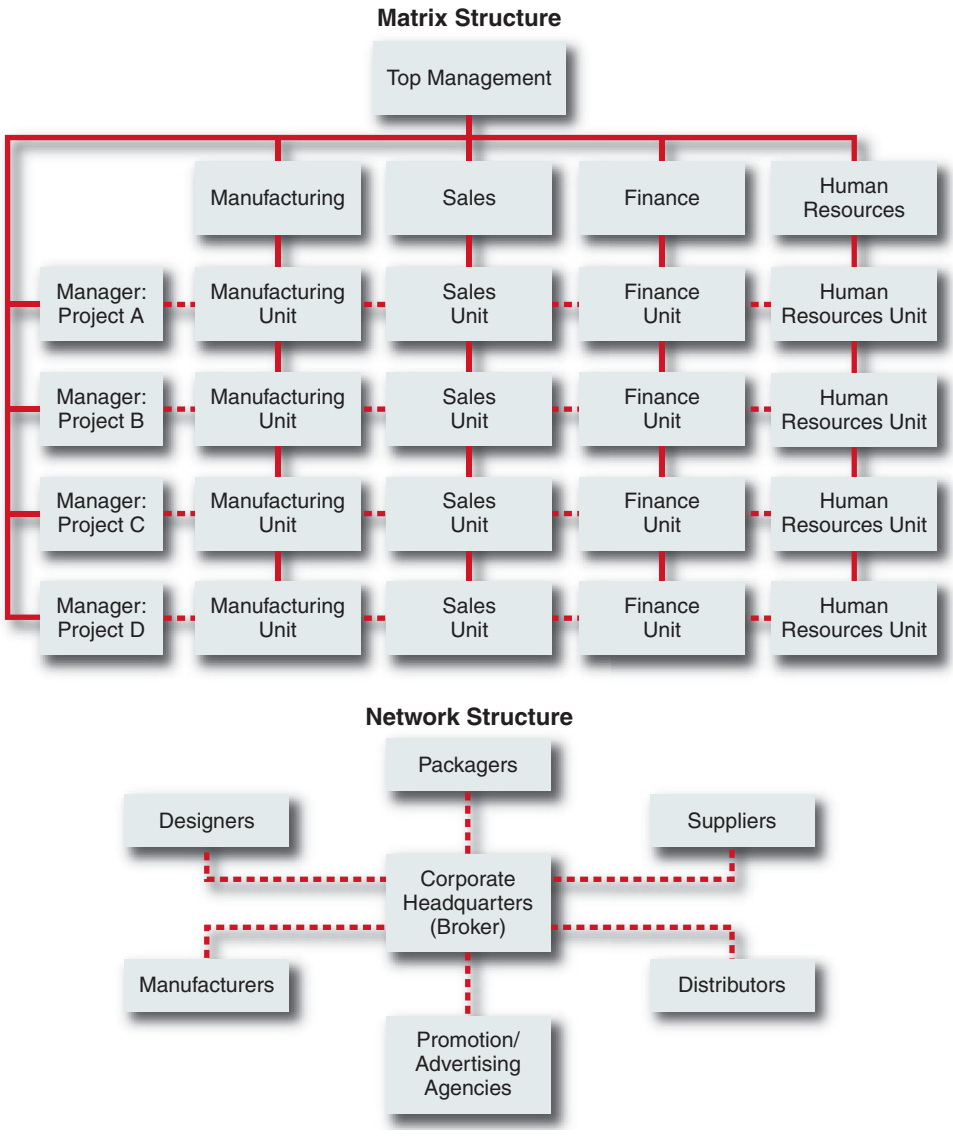
Most organizations find that organizing around either functions (in the functional structure) or products and geography (in the divisional structure) provides an appropriate organizational structure. The matrix structure, in contrast, may be very appropriate when organizations conclude that neither functional nor divisional forms, even when combined with horizontal linking mechanisms such as SBUs, are right for their situations. In **matrix structures,** functional and product forms are combined simultaneously at the same level of the organization. (See **Figure 9–2.**) Employees have two superiors, a product or project manager, and a functional manager. The "home" department—that is, engineering, manufacturing, or sales—is usually functional and is reasonably permanent. People from these functional units are often assigned temporarily to one or more product units or projects. The product units or projects are usually temporary and act like divisions in that they are differentiated on a product-market basis.

TABLE 9–3 Changing Structural Characteristics of Modern Corporations

Old Organization Design	New Organization Design
One large corporation	Minibusiness units and cooperative relationships
Vertical communication	Horizontal communication
Centralized, top-down decision making	Decentralized participative decision making
Vertical integration	Outsourcing and virtual organizations
Work/quality teams	Autonomous work teams
Functional work teams	Cross-functional work teams
Minimal training	Extensive training
Specialized job design focused on individuals	Value-chain team-focused job design

SOURCE: Reprinted from *RESEARCH IN ORGANIZATIONAL CHANGE AND DEVELOPMENT*, Vol. 7, No. 1, 1993, Macy and Izumi, "Organizational Change, Design, and Work Innovation: A Meta-Analysis of 131 North American Field Studies—1961–1991," p. 298. Copyright © 1993 with permission.

FIGURE 9–2
Matrix and Network Structures



Pioneered in the aerospace industry, the matrix structure was developed to combine the stability of the functional structure with the flexibility of the product form. The matrix structure is very useful when the external environment (especially its technological and market aspects) is very complex and changeable. It does, however, produce conflicts revolving around duties, authority, and resource allocation. To the extent that the goals to be achieved are vague and the technology used is poorly understood, a continuous battle for power between product and functional managers is likely. The matrix structure is often found in an organization or SBU when the following three conditions exist:

- Ideas need to be cross-fertilized across projects or products.
- Resources are scarce.
- Abilities to process information and to make decisions need to be improved.[34]

Davis and Lawrence, authorities on the matrix form of organization, propose that *three distinct phases* exist in the development of the matrix structure:[35]

1. **Temporary cross-functional task forces:** These are initially used when a new product line is being introduced. A project manager is in charge as the key horizontal link. J&J's experience with cross-functional teams in its drug group led it to emphasize teams crossing multiple units.
2. **Product/brand management:** If the cross-functional task forces become more permanent, the project manager becomes a product or brand manager and a second phase begins. In this arrangement, function is still the primary organizational structure, but product or brand managers act as the integrators of semi-permanent products or brands. Considered by many a key to the success of P&G, brand management has been widely imitated by other consumer products firms around the world.
3. **Mature matrix:** The third and final phase of matrix development involves a true dual-authority structure. Both the functional and product structures are permanent. All employees are connected to both a vertical functional superior and a horizontal product manager. Functional and product managers have equal authority and must work well together to resolve disagreements over resources and priorities. Boeing, Philips, and TRW Systems are example of companies that use a mature matrix.

Network Structure–The Virtual Organization

A newer and somewhat more radical organizational design, the **network structure** (see **Figure 9–2**) is an example of what could be termed a "non-structure" because of its virtual elimination of in-house business functions. Many activities are outsourced. A corporation organized in this manner is often called a **virtual organization** because it is composed of a series of project groups or collaborations linked by constantly changing nonhierarchical, cobweb-like electronic networks.[36]

The network structure becomes most useful when the environment of a firm is unstable and is expected to remain so.[37] Under such conditions, there is usually a strong need for innovation and quick response. Instead of having salaried employees, the company may contract with people for a specific project or length of time. Long-term contracts with suppliers and distributors replace services that the company could provide for itself through vertical integration. Electronic markets and sophisticated information systems reduce the transaction costs of the marketplace, thus justifying a "buy" over a "make" decision. Rather than being located in a single building or area, the organization's business functions are scattered worldwide. The organization is, in effect, only a shell, with a small headquarters acting as a "broker," electronically connected to some completely owned divisions, partially owned subsidiaries, and other independent companies. In its ultimate form, a network organization is a series of independent firms or business units linked together by computers in an information system that designs, produces, and markets a product or service.[38]

Entrepreneurial ventures often start out as network organizations. For example, Randy and Nicole Wilburn of Dorchester, Massachusetts, run real estate, consulting, design, and baby food companies out of their home. Nicole, a stay-at-home mom and graphic designer, farms out design work to freelancers and cooks her own line of organic baby food. For $300, an Indian artist designed the logo for Nicole's "Baby Fresh Organic Baby Foods." A London freelancer wrote promotional materials. Instead of hiring a secretary, Randy hired "virtual assistants" in Jerusalem to transcribe voice mail, update his Web site, and design PowerPoint graphics. Retired brokers in Virginia and Michigan deal with his real estate paperwork.[39]

Large companies such as Nike, Reebok, and Benetton use the network structure in their operations function by subcontracting (outsourcing) manufacturing to other companies in low-cost locations around the world. For control purposes, the Italian-based Benetton maintains what it calls an "umbilical cord" by assuring production planning for all its subcontractors, planning materials requirements for them, and providing them with bills of labor and standard prices and costs, as well as technical assistance to make sure their quality is up to Benetton's standards.

The network organizational structure provides an organization with increased flexibility and adaptability to cope with rapid technological change and shifting patterns of international trade and competition. It allows a company to concentrate on its distinctive competencies, while gathering efficiencies from other firms that are concentrating their efforts in their areas of expertise. The network does, however, have disadvantages. Some believe that the network is really only a transitional structure because it is inherently unstable and subject to tensions.[40] The availability of numerous potential partners can be a source of trouble. Contracting out individual activities to separate suppliers/distributors may keep the firm from discovering any internal synergies by combining these activities. If a particular firm overspecializes on only a few functions, it runs the risk of choosing the wrong functions and thus becoming noncompetitive.

Cellular/Modular Organization: A New Type of Structure?

Some authorities in the field propose that the evolution of organizational forms is leading from the matrix and the network to the cellular (also called modular) organizational form. According to Miles and Snow et al., "a **cellular organization** is composed of cells (self-managing teams, autonomous business units, etc.) which can operate alone but which can interact with other cells to produce a more potent and competent business mechanism." This combination of independence and interdependence allows the cellular/modular organizational form to generate and share the knowledge and expertise needed to produce continuous innovation. The cellular/modular form includes the dispersed entrepreneurship of the divisional structure, customer responsiveness of the matrix, and self-organizing knowledge and asset sharing of the network.[41] Bombardier, for example, broke up the design of its Continental business jet into 12 parts provided by internal divisions and external contractors. The cockpit, center, and forward fuselage were produced in-house, but other major parts were supplied by manufacturers spread around the globe. The cellular/modular structure is used when it is possible to break up a company's products into self-contained modules or cells and where interfaces can be specified such that the cells/modules work when they are joined together.[42] The cellular/modular structure is similar to a current trend in industry of using internal joint ventures to temporarily combine specialized expertise and skills within a corporation to accomplish a task which individual units alone could not accomplish.[43]

The impetus for such a new structure is the pressure for a continuous process of innovation in all industries. Each cell/module has an entrepreneurial responsibility to the larger organization. Beyond knowledge creation and sharing, the cellular/modular form adds value by keeping the firm's total knowledge assets more fully in use than any other type of structure.[44] It is beginning to appear in firms that are focused on rapid product and service innovation—providing unique or state-of-the-art offerings in industries such as automobile manufacture, bicycle production, consumer electronics, household appliances, power tools, computing products, and software.[45]

REENGINEERING AND STRATEGY IMPLEMENTATION

Reengineering is the radical redesign of business processes to achieve major gains in cost, service, or time. It is not in itself a type of structure, but it is an effective program to implement a turnaround strategy.

Business process reengineering strives to break away from the old rules and procedures that develop and become ingrained in every organization over the years. They may be a combination of policies, rules, and procedures that have never been seriously questioned because they were established years earlier. These may range from "Credit decisions are made by the credit department" to "Local inventory is needed for good customer service." These rules of

organization and work design may have been based on assumptions about technology, people, and organizational goals that may no longer be relevant. Rather than attempting to fix existing problems through minor adjustments and fine-tuning of existing processes, the key to reengineering is asking "If this were a new company, how would we run this place?"

Michael Hammer, who popularized the concept of reengineering, suggests the following principles for reengineering:

- **Organize around outcomes, not tasks:** Design a person's or a department's job around an objective or outcome instead of a single task or series of tasks.
- **Have those who use the output of the process perform the process:** With computer-based information systems, processes can now be reengineered so that the people who need the result of the process can do it themselves.
- **Subsume information-processing work into the real work that produces the information:** People or departments that produce information can also process it for use instead of just sending raw data to others in the organization to interpret.
- **Treat geographically dispersed resources as though they were centralized:** With modern information systems, companies can provide flexible service locally while keeping the actual resources in a centralized location for coordination purposes.
- **Link parallel activities instead of integrating their results:** Instead of having separate units perform different activities that must eventually come together, have them communicate while they work so that they can do the integrating.
- **Put the decision point where the work is performed and build control into the process:** The people who do the work should make the decisions and be self-controlling.
- **Capture information once and at the source:** Instead of having each unit develop its own database and information processing activities, the information can be put on a network so that all can access it.[46]

Studies of the performance of reengineering programs show mixed results. Several companies have had success with business process reengineering. For example, the Mossville Engine Center, a business unit of Caterpillar Inc., used reengineering to decrease process cycle times by 50%, reduce the number of process steps by 45%, reduce human effort by 8%, and improve cross-divisional interactions and overall employee decision making.[47]

One study of North American financial firms found that "the average reengineering project took 15 months, consumed 66 person-months of effort, and delivered cost savings of 24%."[48] In a survey of 782 corporations using reengineering, 75% of the executives said their companies had succeeded in reducing operating expenses and increasing productivity.[49] A study of 134 large and small Canadian companies found that reengineering programs resulted in (1) an increase in productivity and product quality, (2) cost reductions, and (3) an increase in overall organization quality, for both large and small firms.[50] Other studies report, however, that anywhere from 50% to 70% of reengineering programs fail to achieve their objectives.[51] Reengineering thus appears to be more useful for redesigning specific processes like order entry, than for changing an entire organization.[52]

SIX SIGMA

Originally conceived by Motorola as a quality improvement program in the mid-1980s, Six Sigma has become a cost-saving program for all types of manufacturers. Briefly, **Six Sigma** is an analytical method for achieving near-perfect results on a production line. Although the emphasis is on reducing product variance in order to boost quality and efficiency, it is increasingly being applied to accounts receivable, sales, and R&D. In statistics, the Greek letter *sigma*

denotes variation in the standard bell-shaped curve. One sigma equals 690,000 defects per 1 million. Most companies are able to achieve only three sigma, or 66,000 errors per million. Six Sigma reduces the defects to only 3.4 per million—thus saving money by preventing waste. The process of Six Sigma encompasses five steps.

1. *Define* a process where results are poorer than average.
2. *Measure* the process to determine exact current performance.
3. *Analyze* the information to pinpoint where things are going wrong.
4. *Improve* the process and eliminate the error.
5. *Establish* controls to prevent future defects from occurring.[53]

Savings attributed to Six Sigma programs have ranged from 1.2% to 4.5% of annual revenue for a number of Fortune 500 firms. Firms that have successfully employed Six Sigma are General Electric, Allied Signal, ABB, and Ford Motor Company.[54] About 35% of U.S. companies now have a Six Sigma program in place.[55] At Dow Chemical, each Six Sigma project has resulted in cost savings of $500,000 in the first year. According to Jack Welch, GE's past CEO, Six Sigma is an appropriate change program for the entire organization.[56] Six Sigma experts at 3M have been able to speed up R&D and analyze why its top sales people sold more than others. A disadvantage of the program is that training costs in the beginning may outweigh any savings. The expense of compiling and analyzing data, especially in areas where a process cannot be easily standardized, may exceed what is saved.[57] Another disadvantage is that Six Sigma can lead to less-risky incremental innovation based on previous work than on riskier "blue-sky" projects.[58]

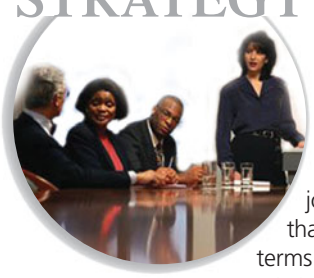
A new program called *Lean Six Sigma* is becoming increasingly popular in companies. This program incorporates the statistical approach of Six Sigma with the lean manufacturing program originally developed by Toyota. Like reengineering, it includes the removal of unnecessary steps in any process and fixing those that remain. This is the "lean" addition to Six Sigma. Xerox used Lean Six Sigma to resolve a problem with a $500,000 printing press it had just introduced. Teams from supply, manufacturing, and R&D used Lean Six Sigma to find the cause of the problem and to resolve it by working with a supplier to change the chemistry of the oil on a roller.[59]

DESIGNING JOBS TO IMPLEMENT STRATEGY

Organizing a company's activities and people to implement strategy involves more than simply redesigning a corporation's overall structure; it also involves redesigning the way jobs are done. With the increasing emphasis on reengineering, many companies are beginning to rethink their work processes with an eye toward phasing unnecessary people and activities out of the process. Process steps that have traditionally been performed sequentially can be improved by performing them concurrently using cross-functional work teams. Harley-Davidson, for example, has managed to reduce total plant employment by 25% while reducing by 50% the time needed to build a motorcycle. Restructuring through needing fewer people requires broadening the scope of jobs and encouraging teamwork. The design of jobs and subsequent job performance are, therefore, increasingly being considered as sources of competitive advantage.

Job design refers to the study of individual tasks in an attempt to make them more relevant to the company and to the employee(s). To minimize some of the adverse consequences of task specialization, corporations have turned to new job design techniques: *job enlargement* (combining tasks to give a worker more of the same type of duties to perform), *job rotation* (moving workers through several jobs to increase variety), and *job enrichment* (altering the jobs by giving the worker more autonomy and control over activities). The *job characteristics*

STRATEGY highlight 9.2



DESIGNING JOBS WITH THE JOB CHARACTERISTICS MODEL

The job characteristics model is an advanced approach to job design based on the belief that tasks can be described in terms of certain objective characteristics and that these characteristics affect employee motivation. In order for a job to be motivating, (1) the worker needs to feel a sense of responsibility, feel the task to be meaningful, and receive useful feedback on his or her performance, and (2) the job has to satisfy needs that are important to the worker. The model proposes that managers follow five principles for redesigning work:

1. Combine tasks to increase task variety and to enable workers to identify with what they are doing.
2. Form natural work units to make a worker more responsible and accountable for the performance of the job.
3. Establish client relationships so the worker will know what performance is required and why.
4. Vertically load the job by giving workers increased authority and responsibility over their activities.
5. Open feedback channels by providing workers with information on how they are performing.

Research supports the job characteristics model as a way to improve job performance through job enrichment. Although there are several other approaches to job design, practicing managers seem increasingly to follow the prescriptions of this model as a way of improving productivity and product quality.

SOURCE: J. R. Hackman and G. R. Oldham, *Work Redesign* (Reading, MA: Addison-Wesley, 1980), pp. 135–141; G. Johns, J. L. Xie, and Y. Fang, "Mediating and Moderating Effects in Job Design," *Journal of Management* (December 1992), pp. 657–676; R. W. Griffin, "Effects of Work Redesign on Employee Perceptions, Attitudes, and Behaviors: A Long-Term Investigation," *Academy of Management Journal* (June 1991), pp. 425–435.

model is a good example of job enrichment. (See **Strategy Highlight 9.2**.) Although each of these methods has its adherents, no one method seems to work in all situations.

A good example of modern job design is the introduction of team-based production by the glass manufacturer Corning Inc., in its Blacksburg, Virginia, plant. With union approval, Corning reduced job classifications from 47 to 4 to enable production workers to rotate jobs after learning new skills. The workers were divided into 14-member teams that, in effect, managed themselves. The plant had only two levels of management: Plant Manager Robert Hoover and two line leaders who only advised the teams. Employees worked demanding 12 ½-hour shifts, alternating three-day and four-day weeks. The teams made managerial decisions, imposed discipline on fellow workers, and were required to learn three "skill modules" within two years or else lose their jobs. As a result of this new job design, a Blacksburg team, made up of workers with interchangeable skills, can retool a line to produce a different type of filter in only 10 minutes—six times faster than workers in a traditionally designed filter plant. The Blacksburg plant earned a $2 million profit in its first eight months of production instead of losing the $2.3 million projected for the startup period. The plant performed so well that Corning's top management acted to convert the company's 27 other factories to team-based production.[60]

9.5 International Issues in Strategy Implementation

An international company is one that engages in any combination of activities, from exporting/importing to full-scale manufacturing, in foreign countries. A **multinational corporation (MNC)**, in contrast, is a highly developed international company with a deep involvement throughout the world, plus a worldwide perspective in its management and decision making.

For an MNC to be considered global, it must manage its worldwide operations as if they were totally interconnected. This approach works best when the industry has moved from being *multidomestic* (each country's industry is essentially separate from the same industry in other countries) to *global* (each country is a part of one worldwide industry).

The global MNC faces the dual challenge of achieving scale economies through standardization while at the same time responding to local customer differences. According to Spulber in his book, *Global Competitive Strategy*, the forces pushing for *standardization* are:

- Convergence in customer preferences and income across target countries.
- Competition from successful global products.
- Growing customer awareness of international brands.
- Economies of scale.
- Falling trading costs across countries.
- Cultural exchange and business interactions among countries.

The forces pushing for *customization* to local markets are:

- Persistent differences in customer preferences.
- Persistent differences in customer incomes.
- The need to build local brand reputation.
- Competition from successful, innovative domestic companies.
- Variations in trading costs across countries.
- Local regulatory requirements.[61]

The design of an organization's structure is strongly affected by the company's stage of development in international activities and the types of industries in which the company is involved. Strategic alliances may complement or even substitute for an internal functional activity. The issue of centralization versus decentralization becomes especially important for an MNC operating in both multidomestic and global industries.

INTERNATIONAL STRATEGIC ALLIANCES

Strategic alliances, such as joint ventures and licensing agreements, between an MNC and a local partner in a host country are becoming increasingly popular as a means by which a corporation can gain entry into other countries, especially less developed countries. The key to the successful implementation of these strategies is the selection of the local partner. Each party needs to assess not only the strategic fit of each company's project strategy but also the fit of each company's respective resources. A successful joint venture may require as much as two years of prior contacts between the parties. A prior relationship helps to develop a level of trust, which facilitates openness in sharing knowledge and a reduced fear of opportunistic behavior by the alliance partners. This is especially important when the environmental uncertainty is high.[62] Research reveals that firms favor past partners when forming new alliances.[63] Key drivers for strategic fit between alliance partners are the following:

- Partners must agree on fundamental values and have a shared vision about the potential for joint value creation.
- Alliance strategy must be derived from business, corporate, and functional strategy.
- The alliance must be important to both partners, especially to top management.
- Partners must be mutually dependent for achieving clear and realistic objectives.

- Joint activities must have added value for customers and the partners.
- The alliance must be accepted by key stakeholders.
- Partners contribute key strengths but protect core competencies.[64]

STAGES OF INTERNATIONAL DEVELOPMENT

Corporations operating internationally tend to evolve through five common stages, both in their relationships with widely dispersed geographic markets and in the manner in which they structure their operations and programs. These **stages of international development** are:

- **Stage 1 (Domestic company):** The primarily domestic company exports some of its products through local dealers and distributors in the foreign countries. The impact on the organization's structure is minimal because an export department at corporate headquarters handles everything.
- **Stage 2 (Domestic company with export division):** Success in Stage 1 leads the company to establish its own sales company with offices in other countries to eliminate the middlemen and to better control marketing. Because exports have now become more important, the company establishes an export division to oversee foreign sales offices.
- **Stage 3 (Primarily domestic company with international division):** Success in earlier stages leads the company to establish manufacturing facilities in addition to sales and service offices in key countries. The company now adds an international division with responsibilities for most of the business functions conducted in other countries.
- **Stage 4 (Multinational corporation with multidomestic emphasis):** Now a full-fledged MNC, the company increases its investments in other countries. The company establishes a local operating division or company in the host country, such as Ford of Britain, to better serve the market. The product line is expanded, and local manufacturing capacity is established. Managerial functions (product development, finance, marketing, and so on) are organized locally. Over time, the parent company acquires other related businesses, broadening the base of the local operating division. As the subsidiary in the host country successfully develops a strong regional presence, it achieves greater autonomy and self-sufficiency. The operations in each country are, nevertheless, managed separately as if each is a domestic company.
- **Stage 5 (MNC with global emphasis):** The most successful MNCs move into a fifth stage in which they have worldwide human resources, R&D, and financing strategies. Typically operating in a global industry, the MNC denationalizes its operations and plans product design, manufacturing, and marketing around worldwide considerations. Global considerations now dominate organizational design. The global MNC structures itself in a matrix form around some combination of geographic areas, product lines, and functions. All managers are responsible for dealing with international as well as domestic issues.

Research provides some support for stages of international development, but it does not necessarily support the preceding sequence of stages. For example, a company may initiate production and sales in multiple countries without having gone through the steps of exporting or having local sales subsidiaries. In addition, any one corporation can be at different stages simultaneously, with different products in different markets at different levels. Firms may also leapfrog across stages to a global emphasis. In addition, most firms that are considered to be stage 5 global MNCs are actually regional. Around 88% of the world's biggest MNCs derive at least half of their sales from their home regions. Just 2% (a total of nine firms) derive 20% or more of their sales from each of the North American, European, and Asian regions.[65]

Developments in information technology are changing the way business is being done internationally. See the **Global Issue** feature for a possible sixth stage of international development, in

GLOBAL issue

MULTIPLE HEADQUARTERS: A SIXTH STAGE OF INTERNATIONAL DEVELOPMENT?

In what could be a sixth stage of international development, an increasing number of MNCs are relocating their headquarters and headquarters functions at multiple locations around the world. Of the 800 corporate headquarters established in 2002, 200 of them were in developing nations. The antivirus software company Trend Micro, for example, spreads its top executives, engineers, and support staff throughout the world to improve its ability to respond to new virus threats. "With the Internet, viruses became global. To fight them, we had to become a global company," explained Chairman Steve Chang. Trend Micro's financial headquarters is in Tokyo, where it went public. Its product development is in Taiwan, and its sales headquarters is in America's Silicon Valley.

C. K. Prahalad, strategy professor at the University of Michigan, proposes that this is a new stage of international development. "There is a fundamental rethinking about what is a multinational company. Does it have a home country? What does headquarters mean? Can you fragment your corporate functions globally?" Corporate headquarters are now becoming virtual with executives and core corporate functions dispersed throughout various world regions. These primarily technology companies are using geography to obtain competitive advantage through the availability of talent or capital, low costs, or proximity to most important customers. Logitech, for example, has its manufacturing headquarters in Taiwan to capitalize on low-cost Asian manufacturing, its business-development headquarters in Switzerland where it has a series of strategic technology partnerships, and a third headquarters in Fremont, California.

SOURCES: S. Hamm, "Borders Are So 20th Century," *Business Week* (January 22, 2003), pp. 68–70; "Globalization from the Top Down," *Futurist* (November–December 2003), p. 13.

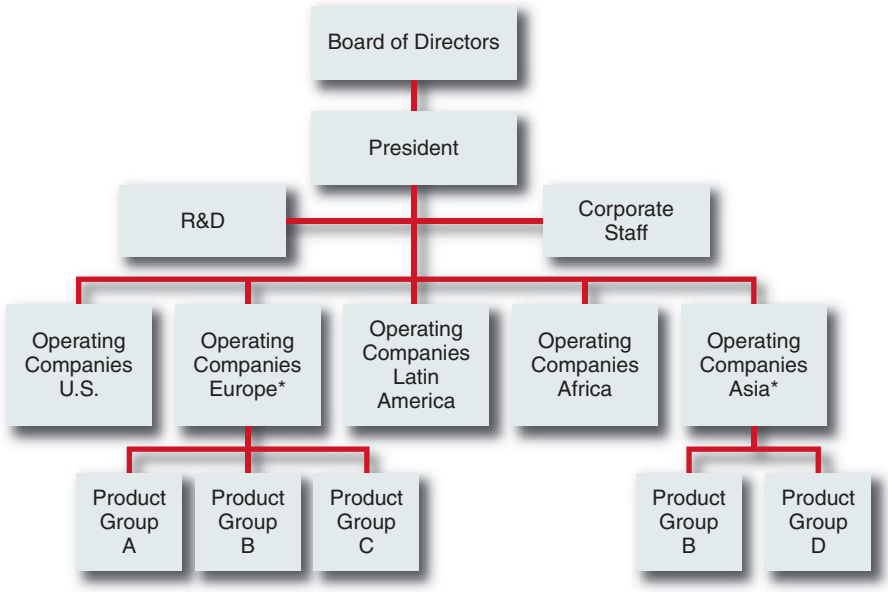
which an MNC locates its headquarters and key functions at multiple locations around the world.[66] Nevertheless, the stages concept provides a useful way to illustrate some of the structural changes corporations undergo when they increase their involvement in international activities.

CENTRALIZATION VERSUS DECENTRALIZATION

A basic dilemma an MNC faces is how to organize authority centrally so that it operates as a vast interlocking system that achieves synergy and at the same time decentralize authority so that local managers can make the decisions necessary to meet the demands of the local market or host government.[67] To deal with this problem, MNCs tend to structure themselves either along product groups or geographic areas. They may even combine both in a matrix structure—the design chosen by 3M Corporation, Philips, and Asea Brown Boveri (ABB), among others.[68] One side of 3M's matrix represents the company's product divisions; the other side includes the company's international country and regional subsidiaries.

Two examples of the usual international structure are Nestlé and American Cyanamid. Nestlé's structure is one in which significant power and authority have been decentralized to geographic entities. This structure is similar to that depicted in **Figure 9–3,** in which each geographic set of operating companies has a different group of products. In contrast, American Cyanamid has a series of centralized product groups with worldwide responsibilities. To depict Cyanamid's structure, the geographical entities in **Figure 9–3** would have to be replaced by product groups or SBUs.

FIGURE 9–3
Geographic Area Structure for an MNC



*NOTE: Because of space limitations, product groups for only Europe and Asia are shown here.

The **product-group structure** of American Cyanamid enables the company to introduce and manage a similar line of products around the world. This enables the corporation to centralize decision making along product lines and to reduce costs. The **geographic-area structure** of Nestlé, in contrast, allows the company to tailor products to regional differences and to achieve regional coordination. For instance, Nestlé markets 200 different varieties of its instant coffee, Nescafé. The geographic-area structure decentralizes decision making to the local subsidiaries.

As industries move from being multidomestic to more globally integrated, MNCs are increasingly switching from the geographic-area to the product-group structure. Nestlé, for example, has found that its decentralized area structure had become increasingly inefficient. As a result, operating margins at Nestlé have trailed those at rivals Unilever, Group Danone, and Kraft Foods by as much as 50%. CEO Peter Brabeck-Letmathe acted to eliminate country-by-country responsibilities for many functions. In one instance, he established five centers worldwide to handle most coffee and cocoa purchasing. Nevertheless, Nestlé is still using three different versions of accounting, planning, and inventory software for each of its main regions—Europe, the Americas, and Asia, Oceania, and Africa.[69]

Simultaneous pressures for decentralization to be locally responsive and centralization to be maximally efficient are causing interesting structural adjustments in most large corporations. This is what is meant by the phrase "think globally, act locally." Companies are attempting to decentralize those operations that are culturally oriented and closest to the customers—manufacturing, marketing, and human resources. At the same time, the companies are consolidating less visible internal functions, such as research and development, finance, and information systems, where there can be significant economies of scale.

End of Chapter SUMMARY

Strategy implementation is where "the rubber hits the road." Environmental scanning and strategy formulation are crucial to strategic management but are only the beginning of the process. The failure to carry a strategic plan into the day-to-day operations of the workplace is a major reason why strategic planning often fails to achieve its objectives. It is discouraging to note that in one study nearly 70% of the strategic plans were never successfully implemented.[70]

For a strategy to be successfully implemented, it must be made action oriented. This is done through a series of programs that are funded through specific budgets and contain new detailed procedures. This is what Sergio Marchionne did when he implemented a turnaround strategy as the new Fiat Group CEO in 2004. He attacked the lethargic, bureaucratic system by flattening Fiat's structure and giving younger managers a larger amount of authority and responsibility. He and other managers worked to reduce the number of auto platforms from 19 to six by 2012. The time from the completion of the design process to new car production was cut from 26 to 18 months. By 2008, the Fiat auto unit was again profitable. Marchionne's next step was to revive the other two underperforming units of Lancia and Alfa Romeo.[71]

This chapter explains how jobs and organizational units can be designed to support a change in strategy. We will continue with staffing and directing issues in strategy implementation in the next chapter.

ECO-BITS

- Only 5% of the 30 million tons of annual plastic waste in the U.S. is currently being recycled.[72]
- Cargill is building the first large-scale manufacturing plant to make soybean-based "polyols," the building blocks of polyurethane. The company says that the use of polyols is a more sustainable option for manufacturers of plastic and ultimately for consumers interested in reducing their environmental footprint.[73]

DISCUSSION QUESTIONS

1. How should a corporation attempt to achieve synergy among functions and business units?
2. How should an owner-manager prepare a company for its movement from Stage I to Stage II?
3. How can a corporation keep from sliding into the Decline stage of the organizational life cycle?
4. Is reengineering just another management fad, or does it offer something of lasting value?
5. How is the cellular/modular structure different from the network structure?

STRATEGIC PRACTICE EXERCISE

The Synergy Game

Yolanda Sarason and Catherine Banbury

Setup

Put three to five chairs on either side of a room, facing each other, in the front of the class. Put a table in the middle, with a bell in the middle of the table.

Procedure

The instructor/moderator divides the class into teams of three to five people. Each team selects a name for itself. The instructor/moderator lists the team names on the board. The first two teams come to the front and sit in the chairs facing each other. The instructor/moderator reads a list of products or services being provided by an actual company. The winning team must

identify (1) possible sources of synergy and (2) the actual company being described. For example, if the products/services listed are family restaurants, airline catering, hotels, and retirement centers, the synergy is ***standardized food service and hospitality settings*** and the company is **The Marriott Corporation**. The first team to successfully name the company *and* the synergy wins the round.

After one practice session, the game begins. Each of the teams is free to discuss the question with other team members. When one of the two teams thinks that it has the answer to both parts of the question, it must be the first to ring the bell in order to announce its answer. If it gives the correct answer, it is deemed the winner of round one. Both parts of the answer must be given for a team to have the correct answer. If a team correctly provides only one part, that answer is still wrong—no partial credit. The instructor/moderator does not say which part of the answer, if either, was correct. The second team then has the opportunity to state the answer. If the second team is wrong, both teams may try once more. If neither chooses to try again, the instructor/moderator may (1) declare no round winner and both teams sit down, (2) allow the next two teams to provide the answer to round one, or (3) go on to the next round with the same two teams. Two new teams then come to the front for the next round. Once all groups have played once, the winning teams play each other. Rounds continue until there is a grand champion. The instructor should provide a suitable prize, such as candy bars, for the winning team.

SOURCE: This exercise was developed by Professors Yolanda Sarason of Colorado State University and Catherine Banbury of St. Mary's College and Purdue University and presented at the Organizational Behavior Teaching Conference, June 1999. Copyright © 1999 by Yolanda Sarason and Catherine Banbury. Adapted with permission.

Note from Wheelen and Hunger

The *Instructors' Manual* for this book contains a list of products and services with their synergy and the name of the company. In case your instructor does not use this exercise, try the following examples:

Example 1: Motorcycles, autos, lawn mowers, generators

Example 2: Athletic footwear, Rockport shoes, Greg Norman clothing, sportswear

For each example, did you guess the company providing these products/services and the synergy obtained? The answers are printed here, upside-down:

Example 1: Engine technology by Honda

Example 2: Marketing and distribution for the athletically-oriented by Reebok

KEY TERMS

budget (p. 276)
cellular organization (p. 288)
geographic-area structure (p. 295)
job design (p. 290)
matrix of change (p. 274)
matrix structure (p. 285)
multinational corporation (MNC) (p. 291)
network structure (p. 287)
organizational life cycle (p. 283)
procedure (p. 276)
product-group structure (p. 295)
program (p. 274)
reengineering (p. 288)
Six Sigma (p. 289)
stages of corporate development (p. 280)
stages of international development (p. 293)
strategy implementation (p. 272)
structure follows strategy (p. 279)
synergy (p. 278)
virtual organization (p. 287)

NOTES

1. A. Bianco, M. Der Hovanesian, L. Young, and P. Gogoi, "Wal-Mart's Midlife Crisis," *Business Week* (April 30, 2007), pp. 46–56; "The Bulldozer of Bentonville Slows," *The Economist* (February 17, 2007), p. 64; D. Kirkpatrick, "Microsoft's New Brain," *Fortune* (May 1, 2006), pp. 56–68; "Spot the Dinosaur," *The Economist* (April 1, 2006), pp. 53–54; J. Greene, "Microsoft's Midlife Crisis," *Business Week* (April 19, 2004), pp. 88–98.
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CHAPTER 10

strategy implementation: staffing and Directing

Have you heard of Enterprise Rent-A-Car? Hertz, Avis, and National Car Rental operations are much more visible at airports. Yet Enterprise owns more cars and operates in more locations than Hertz or Avis. Enterprise began operations in St. Louis in 1957, but didn't locate at an airport until 1995. It is the largest rental car company in North America, but only 230 out of its 7,000 worldwide offices are at airports. In virtually ignoring the highly competitive airport market, Enterprise has chosen a cost-leadership competitive strategy by marketing to people in need of a spare car at neighborhood locations. Its offices are within 15 miles of 90% of the U.S. population. Instead of locating many cars at a few high-priced locations at airports, Enterprise sets up inexpensive offices throughout metropolitan areas. As a result, cars are rented for 30% less than they cost at airports. As soon as one branch office grows to about 150 cars, the company opens another rental office a few miles away. People are increasingly renting from Enterprise even when their current car works fine. According to CEO Andy Taylor, "We call it a 'virtual car.' Small-business people who have to pick up clients call us when they want something better than their own car." Why is this competitive strategy so successful for Enterprise even though its locations are now being imitated by Hertz and Avis?

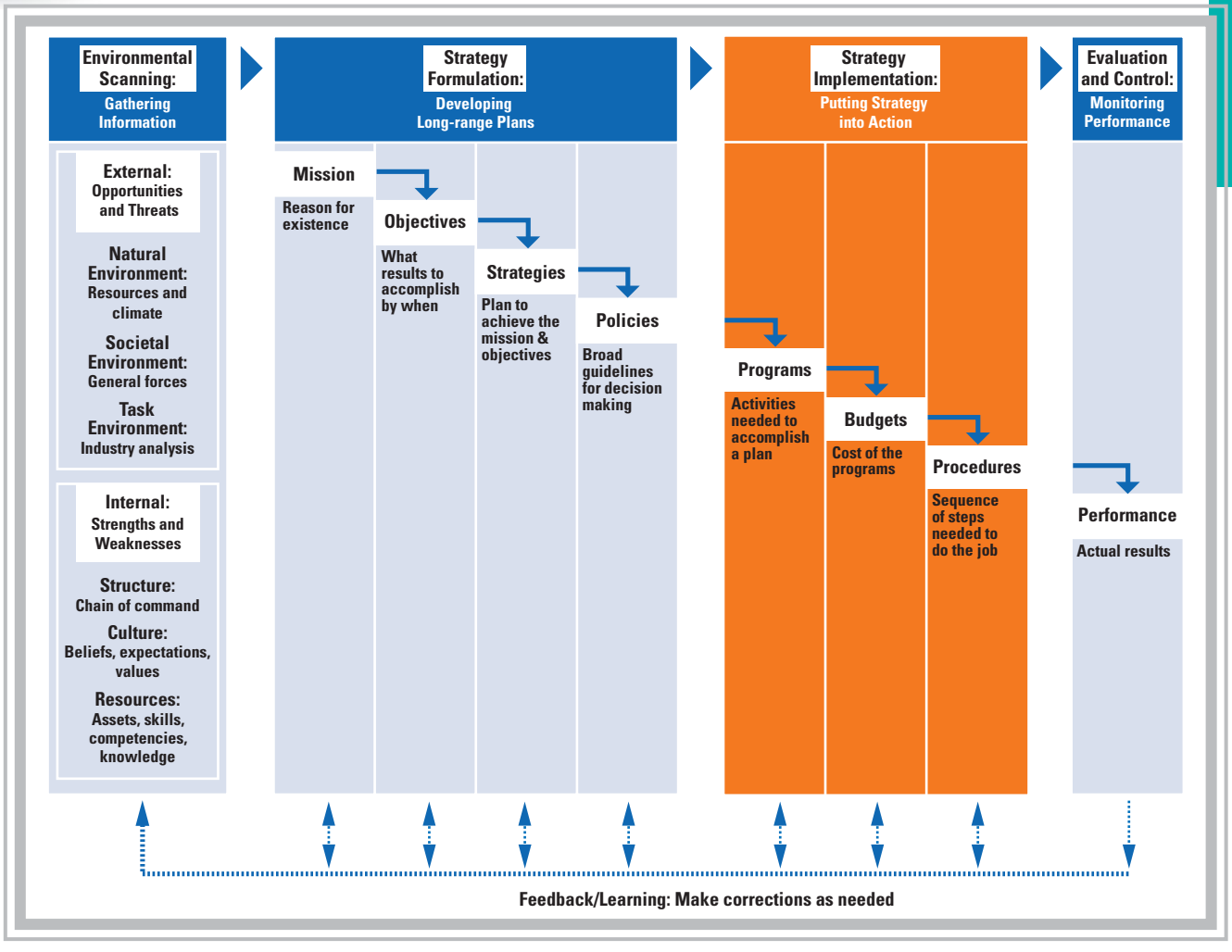
The secret to Enterprise's success is its well-executed strategy implementation. Clearly laid out programs, budgets, and procedures support the company's competitive strategy by making Enterprise stand out in the mind of the consumer. It was ranked on *Business Week*'s list of "Customer Service Champs" in both 2007 and 2008. When a new rental office opens, employees spend time developing relationships with the service managers of every auto dealership and body shop in the area. Enterprise employees bring pizza and doughnuts to workers at the auto garages across the country. Enterprise forms agreements with dealers to provide replacements for cars brought in for service. At major accounts, the company actually staffs an office at the dealership and has cars parked outside so customers don't have to go to an Enterprise office to complete paperwork.

One key to implementation at Enterprise is *staffing*—hiring and promoting a certain kind of person. Virtually every Enterprise employee is a college graduate, usually from the bottom

Learning Objectives

After reading this chapter, you should be able to:

- Understand the link between strategy and staffing decisions
- Match the appropriate manager to the strategy
- Understand how to implement an effective downsizing program
- Discuss important issues in effectively staffing and directing international expansion
- Assess and manage the corporate culture's fit with a new strategy
- Decide when and if programs such as MBO and TQM are appropriate methods of strategy implementation
- Formulate action plans



half of the class. According to COO Donald Ross, "We hire from the half of the college class that makes the upper half possible. We want athletes, fraternity types—especially fraternity presidents and social directors. People people." These new employees begin as management trainees. Instead of regular raises, their pay is tied to branch office profits.

Another key to implementation at Enterprise is *leading*—specifying clear performance objectives and promoting a team-oriented corporate culture. The company stresses promotion from within and advancement based on performance. Every Enterprise employee, including top executives, starts at the bottom. As a result, a bond of shared experience connects all employees and managers. Enterprise was included in *Business Week*'s "50 Best Places to Launch a Career" three years in a row. To reinforce a cohesive culture of camaraderie, senior executives routinely do "grunt work" at branch offices. Even Andy Taylor, the CEO, joins the work. "We were visiting an office in Berkeley and it was mobbed, so I started cleaning cars," says Taylor. "As it was happening, I wondered if it was a good use of my time, but the effect on morale was tremendous." Because the financial results of every branch office and every region are available to all, the collegial culture stimulates good-natured competition. "We're this close to beating out Middlesex," grins Woody Erhardt, an area manager in New Jersey. "I want to pound them into the ground. If they lose, they have to throw a party for us, and we get to decide what they wear."[1]

This example from Enterprise Rent-A-Car illustrates how a strategy must be implemented with carefully considered programs in order to succeed. This chapter discusses strategy implementation in terms of staffing and leading. **Staffing** focuses on the selection and use of employees. **Leading** emphasizes the use of programs to better align employee interests and attitudes with a new strategy.

10.1 Staffing

The implementation of new strategies and policies often calls for new human resource management priorities and a different use of personnel. Such staffing issues can involve hiring new people with new skills, firing people with inappropriate or substandard skills, and/or training existing employees to learn new skills. Research demonstrates that companies with enlightened talent-management policies and programs have higher returns on sales, investments, assets, and equity.[2] This is especially important given that it takes an average of 48 days for an American company to fill a job vacancy at an average cost per hire of $3,270.[3]

If growth strategies are to be implemented, new people may need to be hired and trained. Experienced people with the necessary skills need to be found for promotion to newly created managerial positions. When a corporation follows a growth through acquisition strategy, it may find that it needs to replace several managers in the acquired company. The percentage of an acquired company's top management team that either quit or was asked to leave is around 25% after the first year, 35% after the second year, 48% after the third year, 55% after the fourth year, and 61% after five years.[4] In addition, executives who join an acquired company after the acquisition quit at significantly higher-than-normal rates beginning in their second year. Executives continue to depart at higher-than-normal rates for nine years after the

acquisition.[5] Turnover rates of executives in firms acquired by foreign firms are significantly higher than for firms acquired by domestic firms, primarily in the fourth and fifth years after the acquisition.[6]

It is one thing to lose excess employees after a merger, but it is something else to lose highly skilled people who are difficult to replace. In a study of 40 mergers, 90% of the acquiring companies in the 15 successful mergers identified key employees and targeted them for retention within 30 days after the announcement. In contrast, this task was carried out only in one-third of the unsuccessful acquisitions.[7] To deal with integration issues such as these, some companies are appointing special **integration managers** to shepherd companies through the implementation process. The job of the integrator is to prepare a competitive profile of the combined company in terms of its strengths and weaknesses, draft an ideal profile of what the combined company should look like, develop action plans to close the gap between the actuality and the ideal, and establish training programs to unite the combined company and to make it more competitive.[8] To be a successful integration manager, a person should have (1) a deep knowledge of the acquiring company, (2) a flexible management style, (3) an ability to work in cross-functional project teams, (4) a willingness to work independently, and (5) sufficient emotional and cultural intelligence to work well with people from all backgrounds.[9]

If a corporation adopts a retrenchment strategy, however, a large number of people may need to be laid off or fired (in many instances, being laid off is the same as being fired); and top management, as well as the divisional managers, needs to specify the criteria to be used in making these personnel decisions. Should employees be fired on the basis of low seniority or on the basis of poor performance? Sometimes corporations find it easier to close or sell off an entire division than to choose which individuals to fire.

STAFFING FOLLOWS STRATEGY

As in the case of structure, staffing requirements are likely to follow a change in strategy. For example, promotions should be based not only on current job performance but also on whether a person has the skills and abilities to do what is needed to implement the new strategy.

Changing Hiring and Training Requirements

Having formulated a new strategy, a corporation may find that it needs to either hire different people or retrain current employees to implement the new strategy. Consider the introduction of team-based production at Corning's filter plant mentioned in **Chapter 9**. Employee selection and training were crucial to the success of the new manufacturing strategy. Plant Manager Robert Hoover sorted through 8,000 job applications before hiring 150 people with the best problem-solving ability and a willingness to work in a team setting. Those selected received extensive training in technical and interpersonal skills. During the first year of production, 25% of all hours worked were devoted to training, at a cost of $750,000.[10]

One way to implement a company's business strategy, such as overall low cost, is through training and development. According to the American Society of Training and Development, the average annual expenditure per employee on corporate training and development is $1,000 per employee.[11] A study of 51 corporations in the UK found that 71% of "leading" companies rated staff learning and training as important or very important compared to 62% of the other companies.[12] Another study of 155 U. S. manufacturing firms revealed that those with training programs had 19% higher productivity than did those without such programs. Another study found that a doubling of formal training per employee resulted in a 7% reduction in scrap.[13] Training is especially important for a differentiation strategy emphasizing quality or customer service. For example, Motorola, with annual sales of $17 billion, spends 4% of its payroll on training by providing at least 40 hours of training a year to each employee. There

is a very strong connection between strategy and training at Motorola. For example, after setting a goal to reduce product development cycle time, Motorola created a two-week course to teach its employees how to accomplish that goal. It brought together marketing, product development, and manufacturing managers to create an action learning format in which the managers worked together instead of separately. The company is especially concerned with attaining the highest quality possible in all its operations. Realizing that it couldn't hit quality targets with poor parts, Motorola developed a class for its suppliers on statistical process control. The company estimates that every $1 it spends on training delivers $30 in productivity gains within three years.[14]

Training is also important when implementing a retrenchment strategy. As suggested earlier, successful downsizing means that a company has to invest in its remaining employees. General Electric's Aircraft Engine Group used training to maintain its share of the market even though it had cut its workforce from 42,000 to 33,000 in the 1990s.[15]

Matching the Manager to the Strategy

Executive characteristics influence strategic outcomes for a corporation.[16] It is possible that a current CEO may not be appropriate to implement a new strategy. Research indicates that there may be a career life cycle for top executives. During the early years of executives' tenure, for example, they tend to experiment intensively with product lines to learn about their business. This is their learning stage. Later, their accumulated knowledge allows them to reduce experimentation and increase performance. This is their harvest stage. They enter a decline stage in their later years, when they reduce experimentation still further, and performance declines. Thus, there is an inverted U-shaped relationship between top executive tenure and the firm's financial performance. Some executives retire before any decline occurs. Others stave off decline longer than their counterparts. Because the length of time spent in each stage varies among CEOs, it is up to the board to decide when a top executive should be replaced.[17]

The most appropriate type of general manager needed to effectively implement a new corporate or business strategy depends on the desired strategic direction of that firm or business unit. Executives with a particular mix of skills and experiences may be classified as an **executive type** and paired with a specific corporate strategy. For example, a corporation following a concentration strategy emphasizing vertical or horizontal growth would probably want an aggressive new chief executive with a great deal of experience in that particular industry—a *dynamic industry expert*. A diversification strategy, in contrast, might call for someone with an analytical mind who is highly knowledgeable in other industries and can manage diverse product lines—an *analytical portfolio manager*. A corporation choosing to follow a stability strategy would probably want as its CEO a *cautious profit planner*, a person with a conservative style, a production or engineering background, and experience with controlling budgets, capital expenditures, inventories, and standardization procedures.

Weak companies in a relatively attractive industry tend to turn to a type of challenge-oriented executive known as a *turnaround specialist* to save the company. For example, when former IHOP (International House of Pancakes) waitress Julia Stewart left Applebee's restaurant chain to become CEO of IHOP, she worked to rebuild the company with better food, better ads, and better atmosphere. Six years later, a much improved IHOP acquired the struggling Applebee's restaurant chain. CEO Stewart vowed to turnaround Applebee's within a year by improving service, food quality and focusing the menu on what the restaurant does best: riblets, burgers, and salads. She wanted Applebee's to again be the friendly, neighborhood bar and grill that it once was.[18]

If a company cannot be saved, a *professional liquidator* might be called on by a bankruptcy court to close the firm and liquidate its assets. This is what happened to Montgomery Ward, Inc., the nation's first catalog retailer, which closed its stores for good in 2001, after declaring

bankruptcy for the second time.[19] Research tends to support the conclusion that as a firm's environment changes, it tends to change the type of top executive to implement a new strategy.[20] For example, during the 1990s when the emphasis was on growth in a company's core products/services, the most desired background for a U.S. CEO was either in marketing or international experience. With the current decade's emphasis on mergers, acquisitions, and divestitures, the most desired background is finance. Currently, one out of five American and UK CEOs are former Chief Financial Officers, twice the percentage during the previous decade.[21]

This approach is in agreement with Chandler, who proposes (see **Chapter 9**) that the most appropriate CEO of a company changes as a firm moves from one stage of development to another. Because priorities certainly change over an organization's life, successful corporations need to select managers who have skills and characteristics appropriate to the organization's particular stage of development and position in its life cycle. For example, founders of firms tend to have functional backgrounds in technological specialties, whereas successors tend to have backgrounds in marketing and administration.[22] A change in the environment leading to a change in a company's strategy also leads to a change in the top management team. For example, a change in the U.S. utility industry's environment in 1992 supporting internally focused, efficiency-oriented strategies, led to top management teams being dominated by older managers with longer company and industry tenure, with efficiency-oriented backgrounds in operations, engineering, and accounting.[23] Research reveals that executives having a specific personality characteristic (external locus of control) are more effective in regulated industries than are executives with a different characteristic (internal locus of control).[24]

Other studies have found a link between the type of CEO and a firm's overall strategic type. (Strategic types were presented in **Chapter 4**). For example, successful prospector firms tended to be headed by CEOs from research/engineering and general management backgrounds. High performance defenders tended to have CEOs with accounting/finance, manufacturing/production, and general management experience. Analyzers tended to have CEOs with a marketing/sales background.[25]

A study of 173 firms over a 25-year period revealed that CEOs in these companies tended to have the same functional specialization as the former CEO, especially when the past CEO's strategy continued to be successful. This may be a pattern for successful corporations.[26] In particular, it explains why so many prosperous companies tend to recruit their top executives from one particular area. At Procter & Gamble (P&G)—a good example of an analyzer firm—for example, the route to the CEO's position has traditionally been through brand management, with a strong emphasis on marketing—and more recently international experience. In other firms, the route may be through manufacturing, marketing, accounting, or finance—depending on what the corporation has always considered its core capability (and its overall strategic orientation).

SELECTION AND MANAGEMENT DEVELOPMENT

Selection and development are important not only to ensure that people with the right mix of skills and experiences are initially hired but also to help them grow on the job so that they might be prepared for future promotions.

Executive Succession: Insiders versus Outsiders

Executive succession is the process of replacing a key top manager. The average tenure of a chief executive of a large U.S. company declined from nearly nine years in 1980 to six years in 2006.[27] Given that two-thirds of all major corporations worldwide replace their CEO at least once in a five-year period, it is important that the firm plan for this eventuality.[28] It is especially important for a company that usually promotes from within to prepare its current managers for

promotion. For example, companies using relay executive succession, in which a candidate is groomed to take over the CEO position, have significantly higher performance than those that hire someone from the outside or hold a competition between internal candidates.[29] These "heirs apparent" are provided special assignments including membership on other firms' boards of directors.[30] Nevertheless, only half of large U.S. companies have CEO succession plans in place.[31]

Companies known for being excellent training grounds for executive talent are AlliedSignal, Bain & Company, Bankers Trust, Bristol Myers Squibb, Cititcorp, General Electric, Hewlett-Packard, McDonald's, McKinsey & Company, Microsoft, Nike, PepsiCo, Pfizer, and P&G. For example, one study showed that hiring 19 GE executives into CEO positions added $24.5 billion to the share prices of the companies that hired them. One year after people from GE started their new jobs, 11 of the 19 companies they joined were outperforming their competitors and the overall market.[32]

Some of the best practices for top management succession are encouraging boards to help the CEO create a succession plan, identifying succession candidates below the top layer, measuring internal candidates against outside candidates to ensure the development of a comprehensive set of skills, and providing appropriate financial incentives.[33] Succession planning has become the most important topic discussed by boards of directors.[34] See **Strategy Highlight 10.1** to see how Hewlett-Packard identifies those with potential for executive leadership positions.

Prosperous firms tend to look outside for CEO candidates only if they have no obvious internal candidates.[35] For example, 85% of the CEOs selected to run S&P 500 companies in 2006 were insiders, according to executive search firm Spencer Stuart.[36] Hiring an outsider to be a CEO is a risky gamble. CEOs from the outside tend to introduce significant change and high turnover among the current top management.[37] For example, in one study, the percentage of senior executives that left a firm after a new CEO took office was 20% when the new CEO

STRATEGY highlight 10.1

HOW HEWLETT-PACKARD IDENTIFIES POTENTIAL EXECUTIVES

Hewlett-Packard identifies those with high potential for executive leadership by looking for six broad competencies that the company believes are necessary:

1. *Practice the HP Way* by building trust and respect, focusing on achievement, demonstrating integrity, being innovative with customers, contributing to the community, and developing organizational decision making.
2. *Lead change and learning* by recognizing and acting on signals for change, leading organizational change, learning from organizational experience, removing barriers to change, developing self, and challenging and developing others.
3. *Know the internal and external environments* by anticipating global trends, acting on trends, and learning from others.
4. *Lead strategy setting* by inspiring breakthrough business strategy, leading the strategy-making process, committing to business vision, creating long-range strategies, building financial strategies, and defining a business-planning system.
5. *Align the organization* by working across boundaries, implementing competitive cost structures, developing alliances and partnerships, planning and managing core business, and designing the organization.
6. *Achieve results* by building a track record, establishing accountability, supporting calculated risks, making tough individual decisions, and resolving performance problems.

SOURCE: Summarized from R. M. Fulmer, P. A. Gibbs, and M. Goldsmith, "The New HP Way: Leveraging Strategy with Diversity, Leadership Development and Decentralization," *Strategy & Leadership* (October/November/December, 1999), pp. 21–29.

was an insider, but increased to 34% when the new CEO was an outsider.[38] CEOs hired from outside the firm tend to have a low survival rate. According to RHR International, 40% to 60% of high-level executives brought in from outside a company failed within two years.[39] A study of 392 large U.S. firms revealed that only 16.6% of them had hired outsiders to be their CEOs. The outsiders tended to perform slightly worse than insiders but had a very high variance in performance. Compared to that of insiders, the performance of outsiders tended to be either very good or very poor. Although outsiders performed much better (in terms of shareholder returns) than insiders in the first half of their tenures, they did much worse in their second half. As a result, the average tenure of an outsider was significantly less than for insiders.[40]

Firms in trouble, however, overwhelmingly choose outsiders to lead them.[41] For example, one study of 22 firms undertaking turnaround strategies over a 13-year period found that the CEO was replaced in all but two companies. Of 27 changes of CEO (several firms had more than one CEO during this period), only seven were insiders—20 were outsiders.[42] The probability of an outsider being chosen to lead a firm in difficulty increases if there is no internal heir apparent, if the last CEO was fired, and if the board of directors is composed of a large percentage of outsiders.[43] Boards realize that the best way to force a change in strategy is to hire a new CEO who has no connections to the current strategy.[44] For example, outsiders have been found to be very effective in leading strategic change for firms in Chapter 11 bankruptcy.[45]

Identifying Abilities and Potential

A company can identify and prepare its people for important positions in several ways. One approach is to establish a sound *performance appraisal system* to identify good performers with promotion potential. A survey of 34 corporate planners and human resource executives from 24 large U.S. corporations revealed that approximately 80% made some attempt to identify managers' talents and behavioral tendencies so that they could place a manager with a likely fit to a given competitive strategy.[46] Companies select those people with promotion potential to be in their executive development training program. Approximately 10,000 of GE's 276,000 employees take at least one class at the company's famous Leadership Development Center in Crotonville, New York.[47] Doug Pelino, chief talent officer at Xerox, keeps a list of about 100 managers in middle management and at the vice presidential levels who have been selected to receive special training, leadership experience, and mentorship to become the next generation of top management.[48]

A company should examine its human resource system to ensure not only that people are being hired without regard to their racial, ethnic, or religious background, but also that they are being identified for training and promotion in the same manner. Management diversity could be a competitive advantage in a multi-ethnic world. With more women in the workplace, an increasing number are moving into top management, but are demanding more flexible career ladders to allow for family responsibilities.

Many large organizations are using *assessment centers* to evaluate a person's suitability for an advanced position. Corporations such as AT&T, Standard Oil, IBM, Sears, and GE have successfully used assessment centers. Because each is specifically tailored to its corporation, these assessment centers are unique. They use special interviews, management games, in-basket exercises, leaderless group discussions, case analyses, decision-making exercises, and oral presentations to assess the potential of employees for specific positions. Promotions into these positions are based on performance levels in the assessment center. Assessment centers have generally been able to accurately predict subsequent job performance and career success.[49]

Job rotation—moving people from one job to another—is also used in many large corporations to ensure that employees are gaining the appropriate mix of experiences to prepare them for future responsibilities. Rotating people among divisions is one way that a corporation can improve the level of organizational learning. General Electric, for example, routinely

rotates its executives from one sector to a completely different one to learn the skills of managing in different industries. Jeffrey Immelt, who took over as CEO from Jack Welch, had managed businesses in plastics, appliances, and medical systems.[50] Companies that pursue related diversification strategies through internal development make greater use of interdivisional transfers of people than do companies that grow through unrelated acquisitions. Apparently, the companies that grow internally attempt to transfer important knowledge and skills throughout the corporation in order to achieve some sort of synergy.[51]

PROBLEMS IN RETRENCHMENT

On January 28, 2009, Starbucks announced that it was closing 300 stores in addition to the 600 closures it had announced earlier and thus reduce its workforce by 7,000 people. Meanwhile, Hershey Foods closed six plants in the U.S. and Canada and eliminated 3,000 U.S. jobs. Like other companies at the time, both firms were experiencing declining sales and profits and attempting to cut costs. Due to a poor economy, more than 2.1 million U.S. workers were laid off in 2008. **Downsizing** (sometimes called "rightsizing" or "resizing") refers to the planned elimination of positions or jobs. This program is often used to implement retrenchment strategies. Because the financial community is likely to react favorably to announcements of downsizing from a company in difficulty, such a program may provide some short-term benefits such as raising the company's stock price. If not done properly, however, downsizing may result in less, rather than more, productivity. One study found that a 10% reduction in people resulted in only a 1.5% reduction in costs, profits increased in only half the firms downsizing, and the stock prices of downsized firms increased over three years, but not as much as did those of firms that did not downsize.[52] Why were the results so marginal?

A study of downsizing at automobile-related U.S. industrial companies revealed that at 20 out of 30 companies, either the wrong jobs were eliminated or blanket offers of early retirement prompted managers, even those considered invaluable, to leave. After the layoffs, the remaining employees had to do not only their work but also the work of the people who had gone. Because the survivors often didn't know how to do the departeds' work, morale and productivity plummeted.[53] Downsizing can seriously damage the learning capacity of organizations.[54] Creativity drops significantly (affecting new product development), and it becomes very difficult to keep high performers from leaving the company.[55] In addition, cost-conscious executives tend to defer maintenance, skimp on training, delay new product introductions, and avoid risky new businesses—all of which leads to lower sales and eventually to lower profits.[56] These are some of the reasons why layoffs worry customers and have a negative effect on a firm's reputation.[57]

A good retrenchment strategy can thus be implemented well in terms of organizing but poorly in terms of staffing. A situation can develop in which retrenchment feeds on itself and acts to further weaken instead of strengthen the company. Research indicates that companies undertaking cost-cutting programs are four times more likely than others to cut costs again, typically by reducing staff.[58] This happened at Eastman Kodak, Xerox, Ford, and General Motors during the 1990s, but 10 years later the companies were still downsizing and working to regain their profitable past performance. In contrast, successful downsizing firms undertake a strategic reorientation, not just a bloodletting of employees. Research shows that when companies use downsizing as part of a larger restructuring program to narrow company focus, they enjoy better performance.[59]

Consider the following guidelines that have been proposed for successful downsizing:

- **Eliminate unnecessary work instead of making across-the-board cuts:** Spend the time to research where money is going and eliminate the task, not the workers, if it doesn't add value to what the firm is producing. Reduce the number of administrative levels rather

than the number of individual positions. Look for interdependent relationships before eliminating activities. Identify and protect core competencies.

- **Contract out work that others can do cheaper:** For example, Bankers Trust of New York contracted out its mailroom and printing services and some of its payroll and accounts payable activities to a division of Xerox. Outsourcing may be cheaper than vertical integration.
- **Plan for long-run efficiencies:** Don't simply eliminate all postponable expenses, such as maintenance, R&D, and advertising, in the unjustifiable hope that the environment will become more supportive. Continue to hire, grow, and develop—particularly in critical areas.
- **Communicate the reasons for actions:** Tell employees not only why the company is downsizing but also what the company is trying to achieve. Promote educational programs.
- **Invest in the remaining employees:** Because most "survivors" in a corporate downsizing will probably be doing different tasks from what they were doing before the change, firms need to draft new job specifications, performance standards, appraisal techniques, and compensation packages. Additional training is needed to ensure that everyone has the proper skills to deal with expanded jobs and responsibilities. Empower key individuals/groups and emphasize team building. Identify, protect, and mentor people who have leadership talent.
- **Develop value-added jobs to balance out job elimination:** When no other jobs are currently available within the organization to transfer employees to, management must consider other staffing alternatives. For example, Harley-Davidson worked with the company's unions to find other work for surplus employees by moving into Harley plants work that had previously been done by suppliers.[60]

INTERNATIONAL ISSUES IN STAFFING

Implementing a strategy of international expansion takes a lot of planning and can be very expensive. Nearly 80% of midsize and larger companies send their employees abroad, and 45% plan to increase the number they have on foreign assignment. A complete package for one executive working in another country costs from $300,000 to $1 million annually. Nevertheless, between 10% and 20% of all U.S. managers sent abroad returned early because of job dissatisfaction or difficulties in adjusting to a foreign country. Of those who stayed for the duration of their assignment, nearly one-third did not perform as well as expected. One-fourth of those completing an assignment left their company within one year of returning home—often leaving to join a competitor.[61] One common mistake is failing to educate the person about the customs and values in other countries.

Because of cultural differences, managerial style and human resource practices must be tailored to fit the particular situations in other countries. Because only 11% of human resource managers have ever worked abroad, most have little understanding of a global assignment's unique personal and professional challenges and thus fail to develop the training necessary for such an assignment.[62] Ninety percent of companies select employees for an international assignment based on their technical expertise while ignoring other areas.[63] A lack of knowledge of national and ethnic differences can make managing an international operation extremely difficult. For example, the three ethnic groups living in Malaysia (Malay, Chinese, and Indian) share different religions, attend different schools, and do not like to work in the same factories with each other. Because of the importance of cultural distinctions such as these, multinational corporations (MNCs) are now putting more emphasis on intercultural training for managers

being sent on an assignment to a foreign country. This type of training is one of the commonly cited reasons for the lower expatriate failure rates—6% or less—for European and Japanese MNCs, which have emphasized cross-cultural experiences, compared with a 35% failure rate for U.S.-based MNCs.[64]

To improve organizational learning, many MNCs are providing their managers with international assignments lasting as long as five years. Upon their return to headquarters, these expatriates have an in-depth understanding of the company's operations in another part of the world. This has value to the extent that these employees communicate this understanding to others in decision-making positions. Research indicates that an MNC performs at a higher level when its CEO has international experience.[65] Global MNCs, in particular, emphasize international experience, have a greater number of senior managers who have been expatriates, and have a strong focus on leadership development through the expatriate experience.[66] Unfortunately, not all corporations appropriately manage international assignments. While out of the country, a person may be overlooked for an important promotion (out of sight, out of mind). Upon his or her return to the home country, co-workers may deprecate the out-of country experience as a waste of time. The perceived lack of organizational support for international assignments increases the likelihood that an expatriate will return home early.[67]

From their study of 750 U.S., Japanese, and European companies, Black and Gregersen found that the companies that do a good job of managing foreign assignments follow three general practices:

- When making international assignments, they focus on transferring knowledge and developing global leadership.
- They make foreign assignments to people whose technical skills are matched or exceeded by their cross-cultural abilities.
- They end foreign assignments with a deliberate repatriation process, with career guidance and jobs where the employees can apply what they learned in their assignments.[68]

Once a corporation has established itself in another country, it hires and promotes people from the host country into higher-level positions. For example, most large MNCs attempt to fill managerial positions in their subsidiaries with well-qualified citizens of the host countries. Unilever and IBM have traditionally taken this approach to international staffing. This policy serves to placate nationalistic governments and to better attune management practices to the host country's culture. The danger in using primarily foreign nationals to staff managerial positions in subsidiaries is the increased likelihood of suboptimization (the local subsidiary ignores the needs of the larger parent corporation). This makes it difficult for an MNC to meet its long-term, worldwide objectives. To a local national in an MNC subsidiary, the corporation as a whole is an abstraction. Communication and coordination across subsidiaries become more difficult. As it becomes harder to coordinate the activities of several international subsidiaries, an MNC will have serious problems operating in a global industry.

Another approach to staffing the managerial positions of MNCs is to use people with an "international" orientation, regardless of their country of origin or host country assignment. This is a widespread practice among European firms. For example, Electrolux, a Swedish firm, had a French director in its Singapore factory. Using third-country "nationals" can allow for more opportunities for promotion than does Unilever's policy of hiring local people, but it can also result in more misunderstandings and conflicts with the local employees and with the host country's government.

Some corporations take advantage of immigrants and their children to staff key positions when negotiating entry into another country and when selecting an executive to manage the company's new foreign operations. For example, when General Motors wanted to learn more about business opportunities in China, it turned to Shirley Young, a Vice President of Marketing

at GM. Born in Shanghai and fluent in Chinese language and customs, Young was instrumental in helping GM negotiate a $1 billion joint venture with Shanghai Automotive to build a Buick plant in China. With other Chinese-Americans, Young formed a committee to advise GM on relations with China. Although just a part of a larger team of GM employees working on the joint venture, Young coached GM employees on Chinese customs and traditions.[69]

MNCs with a high level of international interdependence among activities need to provide their managers with significant international assignments and experiences as part of their training and development. Such assignments provide future corporate leaders with a series of valuable international contacts in additional to a better personal understanding of international issues and global linkages among corporate activities.[70] Research reveals that corporations using cross-national teams, whose members have international experience and communicate frequently with overseas managers, have greater product development capabilities than others.[71] Executive recruiters report that more major corporations are now requiring candidates to have international experience.[72] To increase its own top management's global expertise, Cisco Systems introduced a staffing program in 2007 with the objective of locating 20% of its senior managers at its new Bangalore, India, Globalization Center by 2010.[73]

Since an increasing number of multinational corporations are primarily organized around business units and product lines instead of geographic areas, product and SBU managers who are based at corporate headquarters are often traveling around the world to work personally with country managers. These managers and other mobile workers are being called *stealth expatriates* because they are either cross-border commuters (especially in the EU) or the accidental expatriate who goes on many business trips or temporary assignments due to offshoring and/or international joint ventures.[74]

10.2 Leading

Implementation also involves leading through coaching people to use their abilities and skills most effectively and efficiently to achieve organizational objectives. Without direction, people tend to do their work according to their personal view of what tasks should be done, how, and in what order. They may approach their work as they have in the past or emphasize those tasks that they most enjoy—regardless of the corporation's priorities. This can create real problems, particularly if the company is operating internationally and must adjust to customs and traditions in other countries. This direction may take the form of management leadership, communicated norms of behavior from the corporate culture, or agreements among workers in autonomous work groups. It may be accomplished more formally through action planning or through programs, such as Management By Objectives and Total Quality Management. Procedures can be changed to provide incentives to motivate employees to align their behavior with corporate objectives. For an example of Abbott Laboratories' new procedures to motivate employees to drive carbon neutral autos, see the **Environmental Sustainability Issue** feature.

MANAGING CORPORATE CULTURE

Because an organization's culture can exert a powerful influence on the behavior of all employees, it can strongly affect a company's ability to shift its strategic direction. A problem for a strong culture is that a change in mission, objectives, strategies, or policies is not likely to be successful if it is in opposition to the accepted culture of the company. Corporate culture has a strong tendency to resist change because its very reason for existence often rests on preserving stable relationships and patterns of behavior. For example, when Robert Nardelli became

ENVIRONMENTAL sustainability issue

ABBOTT LABORATORIES' NEW PROCEDURES FOR GREENER COMPANY CARS

Abbott Laboratories, which provides its sales staff with 6,000 vehicles, has changed its procedures for mileage reimbursement in order to make its car fleet more carbon neutral. Under previous rules, Abbott's employees reimbursed the company for *personal* use of company cars at 17.3¢ per mile. Starting January 2009, those choosing SUVs were required to pay **72.3¢** per mile. As a result, 48% of the sales reps selected sedans compared to only 25% in 2008. Requests for SUVs dropped from 44% of the sales reps the previous year to 29% in 2009. Requests for hybrid autos increased from 6% in 2008 to 18% in 2009.

SOURCE: Summarized from D. Kiley, "Steering Workers into the Green Lane," *Business Week* (October 27, 2008), p. 18.

CEO at Home Depot in 2000, he changed the corporate strategy to growing the company's small professional supply business (sales to building contractors) through acquisitions and making the mature retail business cost-effective. He attempted to replace the old informal entrepreneurial collaborative culture with one of military efficiency. Before Nardelli's arrival, most store managers had based their decisions upon their personal knowledge of their customers' preferences. Under Nardelli, they were instead given weekly sales and profit targets. Underperforming managers were asked to leave the company. The once-heavy ranks of full-time employees were replaced with cheaper part-timers. In this "culture of fear," morale fell and Home Depot's customer satisfaction score dropped to last place among major U.S. retailers. By 2007, Nardelli was asked to leave the company.

There is no one best corporate culture. An optimal culture is one that best supports the mission and strategy of the company of which it is a part. This means that *corporate culture should support the strategy*. Unless strategy is in complete agreement with the culture, any significant change in strategy should be followed by a modification of the organization's culture. Although corporate culture can be changed, it may often take a long time, and it requires much effort. At Home Depot, for example, CEO Nardelli attempted to change the corporate culture by hiring GE veterans like himself into top management positions, hiring ex-military officers as store managers, and instituting a top-down command structure.

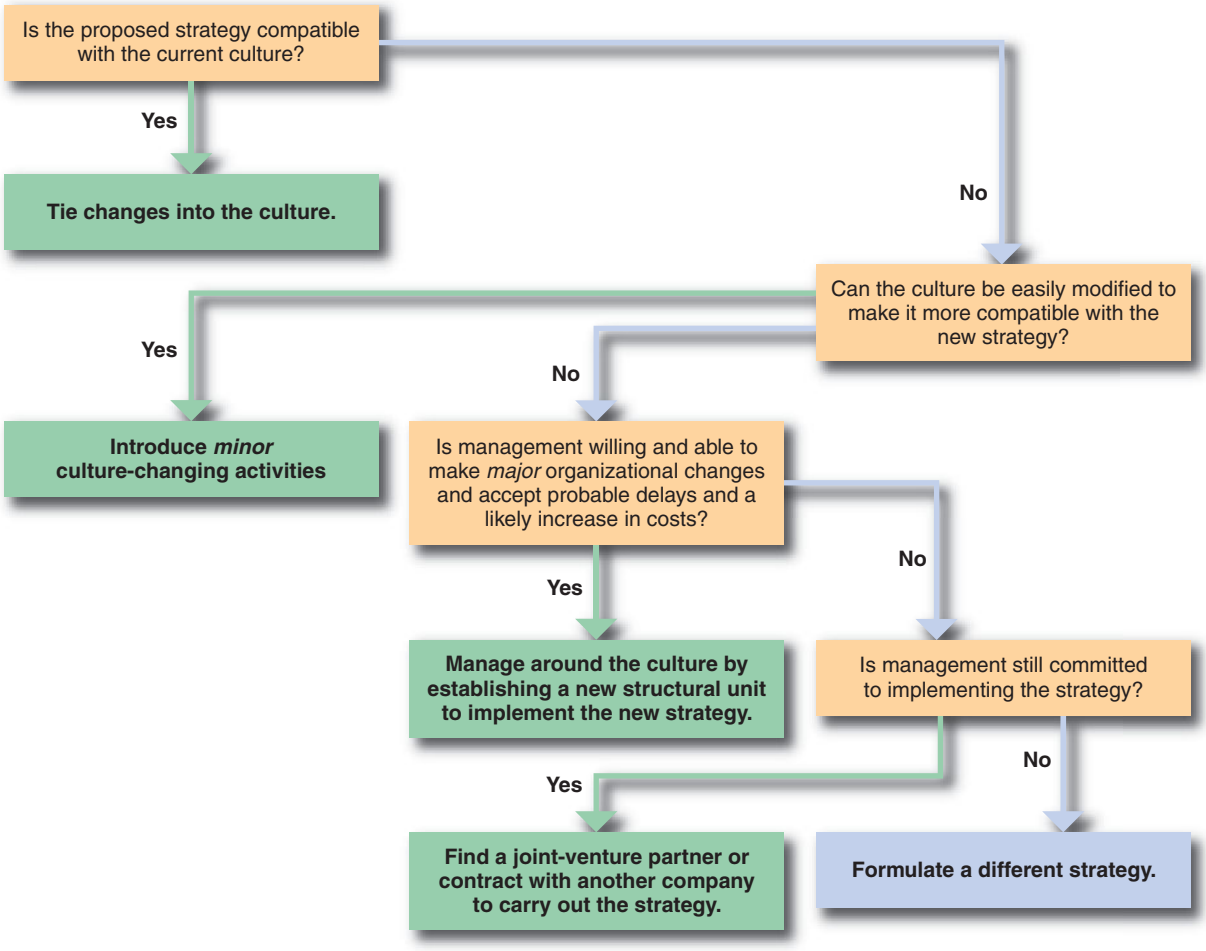
A key job of management involves managing corporate culture. In doing so, management must evaluate what a particular change in strategy means to the corporate culture, assess whether a change in culture is needed, and decide whether an attempt to change the culture is worth the likely costs.

Assessing Strategy-Culture Compatibility

When implementing a new strategy, a company should take the time to assess *strategy-culture compatibility.* (See **Figure 10–1**.) Consider the following questions regarding a corporation's culture:

1. **Is the proposed strategy compatible with the company's current culture?** *If yes*, full steam ahead. Tie organizational changes into the company's culture by identifying how the new strategy will achieve the mission better than the current strategy does. *If not . . .*
2. **Can the culture be easily modified to make it more compatible with the new strategy?** *If yes,* move forward carefully by introducing a set of culture-changing activities such as minor structural modifications, training and development activities, and/or hiring new managers who are more compatible with the new strategy. When Procter & Gamble's

FIGURE 10–1 Assessing Strategy–Culture Compatibility



top management decided to implement a strategy aimed at reducing costs, for example, it made some changes in how things were done, but it did not eliminate its brand-management system. The culture adapted to these modifications over a couple years and productivity increased. *If not* . . .

3. **Is management willing and able to make major organizational changes and accept probable delays and a likely increase in costs?** *If yes*, manage around the culture by establishing a new structural unit to implement the new strategy. At General Motors, for example, top management realized the company had to make some radical changes to be more competitive. Because the current structure, culture, and procedures were very inflexible, management decided to establish a completely new Saturn division (GM's first new division since 1918) to build its new auto. In cooperation with the United Auto Workers, an entirely new labor agreement was developed, based on decisions reached by consensus. Carefully selected employees received from 100 to 750 hours of training, and a whole new culture was built, piece by piece. *If not* . . .
4. **Is management still committed to implementing the strategy?** *If yes*, find a joint-venture partner or contract with another company to carry out the strategy. *If not*, formulate a different strategy.

Based on Robert Nardelli's decisions when he initially started as Home Depot's CEO, he probably answered "no" to the first question and "yes" to the second question—thus justifying his many changes in staffing and leading. Unfortunately, these changes didn't work very well. Instead, he should have replied "no" to the first and second questions and stopped at the third question. As suggested by this question, he should have considered a different corporate strategy, such as growing the professional side of the business without changing the collegial culture of the retail stores. Not surprisingly, once Nardelli was replaced by a new CEO, the company divested the professional supply companies that Nardelli had spent so much time and money acquiring and returned to its previous strategy of concentrating on Home Depot retail stores.

Managing Cultural Change Through Communication

Communication is key to the effective management of change. A survey of 3,199 world-wide executives by McKinsey & Company revealed that ongoing communication and involvement was the approach most used by companies that successfully transformed themselves.[75] Rationale for strategic changes should be communicated to workers not only in newsletters and speeches, but also in training and development programs. This is especially important in decentralized firms where a large number of employees work in far-flung business units.[76] Companies in which major cultural changes have successfully taken place had the following characteristics in common:

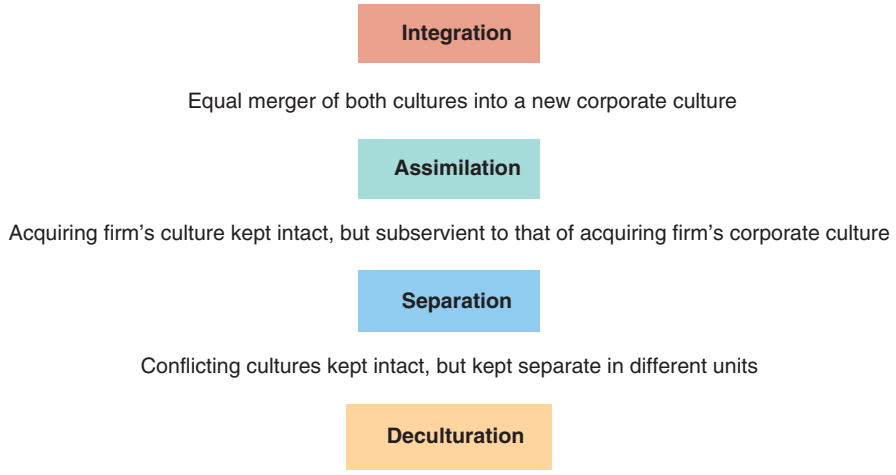
- The CEO and other top managers had a strategic vision of what the company could become and communicated that vision to employees at all levels. The current performance of the company was compared to that of its competition and constantly updated.
- The vision was translated into the key elements necessary to accomplish that vision. For example, if the vision called for the company to become a leader in quality or service, aspects of quality and service were pinpointed for improvement, and appropriate measurement systems were developed to monitor them. These measures were communicated widely through contests, formal and informal recognition, and monetary rewards, among other devices.[77]

For example, when Pizza Hut, Taco Bell, and KFC were purchased by Tricon Global Restaurants (now Yum! Brands) from PepsiCo, the new management knew that it had to create a radically different culture than the one at PepsiCo if the company was to succeed. To begin, management formulated a statement of shared values—"How We Work Together" principles. They declared their differences with the "mother country" (PepsiCo) and wrote a "Declaration of Independence" stating what the new company would stand for. Restaurant managers participated in team-building activities at the corporate headquarters and finished by signing the company's "Declaration of Independence" as "founders" of the company. Since then, "Founder's Day" has become an annual event celebrating the culture of the company. Headquarters was renamed the "Restaurant Support Center," signifying the cultural value that the restaurants were the central focus of the company. People measures were added to financial measures and customer measures, reinforcing the "putting people first" value. In an unprecedented move in the industry, restaurant managers were given stock options and added to the list of performance incentives. The company created values-focused 360-degree performance reviews, which were eventually pushed to the restaurant manager level.[78]

Managing Diverse Cultures Following an Acquisition

When merging with or acquiring another company, top management must give some consideration to a potential clash of corporate cultures. According to a Hewitt Associates survey of 218 major U.S. corporations, integrating culture was a top challenge for 69% of the reporting companies.[79] Cultural differences are even more problematic when a company acquires a firm in another country. DaimlerChrysler's purchase of a controlling interest in Mitsubishi Motors in 2001 was insufficient to overcome Mitsubishi's resistance to change. After investing

FIGURE 10–2
Methods of Managing the Culture of an Acquired Firm



SOURCE: Based on A. R. Malezadeh and A. Nahavandi, "Making Mergers Work in Managing Cultures," *Journal of Business Strategy* (May/June 1990), pp. 53–57 and "Acculturation in Mergers and Acquisitions," *Academy of Management Review* (January 1988), pp. 79–90.

$2 billion to cut Mitsubishi's costs and improve its product development, DaimlerChrysler gave up.[80] It's dangerous to assume that the firms can simply be integrated into the same reporting structure. The greater the gap between the cultures of the acquired firm and the acquiring firm, the faster executives in the acquired firm quit their jobs and valuable talent is lost. Conversely, when corporate cultures are similar, performance problems are minimized.[81]

There are four general methods of managing two different cultures. (See **Figure 10–2**.) The choice of which method to use should be based on (1) *how much members of the acquired firm value preserving their own culture* and (2) *how attractive they perceive the culture of the acquirer to be.*[82]

1. *Integration* involves a relatively balanced give-and-take of cultural and managerial practices between the merger partners, and no strong imposition of cultural change on either company. It merges the two cultures in such a way that the separate cultures of both firms are preserved in the resulting culture. This is what occurred when France's Renault purchased a controlling interest in Japan's Nissan Motor Company and installed Carlos Ghosn as Nissan's new CEO to turn around the company. Ghosn was very sensitive to Nissan's culture and allowed the company room to develop a new corporate culture based on the best elements of Japan's national culture. His goal was to form one successful auto group from two very distinct companies.[83]
2. *Assimilation* involves the domination of one organization over the other. The domination is not forced, but it is welcomed by members of the acquired firm, who may feel for many reasons that their culture and managerial practices have not produced success. The acquired firm surrenders its culture and adopts the culture of the acquiring company. This was the case when Maytag Company (now part of Whirlpool) acquired Admiral. Because Admiral's previous owners had not kept the manufacturing facilities up to date, quality had drastically fallen over the years. Admiral's employees were willing to accept the dominance of Maytag's strong quality-oriented culture because they respected it and knew that without significant changes at Admiral, they would soon be out of work. In turn, they expected to be treated with some respect for their skills in refrigeration technology.

3. *Separation* is characterized by a separation of the two companies' cultures. They are structurally separated, without cultural exchange. When Boeing acquired McDonnell-Douglas, known for its expertise in military aircraft and missiles, Boeing created a separate unit to house both McDonnell's operations and Boeing's own military business. McDonnell executives were given top posts in the new unit and other measures were taken to protect the strong McDonnell culture. On the commercial side, where Boeing had the most expertise, McDonnell's commercial operations were combined with Boeing's in a separate unit managed by Boeing executives.[84]
4. *Deculturation* involves the disintegration of one company's culture resulting from unwanted and extreme pressure from the other to impose its culture and practices. This is the most common and most destructive method of dealing with two different cultures. It is often accompanied by much confusion, conflict, resentment, and stress. This is a primary reason why so many executives tend to leave after their firm is acquired. Such a merger typically results in poor performance by the acquired company and its eventual divestment. This is what happened when AT&T acquired NCR Corporation in 1990 for its computer business. It replaced NCR managers with an AT&T management team, reorganized sales, forced employees to adhere to the AT&T code of values (called the "Common Bond"), and even dropped the proud NCR name (successor to National Cash Register) in favor of a sterile GIS (Global Information Solutions) nonidentity. By 1995, AT&T was forced to take a $1.2 billion loss and lay off 10,000 people.[85] The NCR unit was consequently sold.

ACTION PLANNING

Activities can be directed toward accomplishing strategic goals through action planning. At a minimum, an **action plan** states what actions are going to be taken, by whom, during what time frame, and with what expected results. After a program has been selected to implement a particular strategy, an action plan should be developed to put the program in place. **Table 10–1** shows an example of an action plan for a new advertising and promotion program.

Take the example of a company choosing forward vertical integration through the acquisition of a retailing chain as its growth strategy. Once it owns its own retail outlets, it must integrate the stores into the company. One of the many programs it would have to develop is a new advertising program for the stores. The resulting action plan to develop a new advertising program should include much of the following information:

1. **Specific actions to be taken to make the program operational:** One action might be to contact three reputable advertising agencies and ask them to prepare a proposal for a new radio and newspaper ad campaign based on the theme "Jones Surplus is now a part of Ajax Continental. Prices are lower. Selection is better."
2. **Dates to begin and end each action:** Time would have to be allotted not only to select and contact three agencies, but to allow them sufficient time to prepare a detailed proposal. For example, allow one week to select and contact the agencies plus three months for them to prepare detailed proposals to present to the company's marketing director. Also allow some time to decide which proposal to accept.
3. **Person (identified by name and title) responsible for carrying out each action:** List someone—such as Jan Lewis, advertising manager—who can be put in charge of the program.
4. **Person responsible for monitoring the timeliness and effectiveness of each action:** Indicate that Jan Lewis is responsible for ensuring that the proposals are of good quality and are priced within the planned program budget. She will be the primary company contact for the ad agencies and will report on the progress of the program once a week to the company's marketing director.

TABLE 10–1 Example of an Action Plan

Action Plan for Jan Lewis, Advertising Manager, and Rick Carter, Advertising Assistant, Ajax Continental

Program Objective: To Run a New Advertising and Promotion Campaign for the Combined Jones Surplus/Ajax Continental Retail Stores for the Coming Christmas Season within a Budget of $XX.

Program Activities:

1. Identify Three Best Ad Agencies for New Campaign.
2. Ask Three Ad Agencies to Submit a Proposal for a New Advertising and Promotion Campaign for Combined Stores.
3. Agencies Present Proposals to Marketing Manager.
4. Select Best Proposal and Inform Agencies of Decision.
5. Agency Presents Winning Proposal to Top Management.
6. Ads Air on TV and Promotions Appear in Stores.
7. Measure Results of Campaign in Terms of Viewer Recall and Increase in Store Sales.

Action Steps	Responsibility	Start–End
1. A. Review previous programs	Lewis & Carter	1/1–2/1
B. Discuss with boss	Lewis & Smith	2/1–2/3
C. Decide on three agencies	Lewis	2/4
2. A. Write specifications for ad	Lewis	1/15–1/20
B. Assistant writes ad request	Carter	1/20–1/30
C. Contact ad agencies	Lewis	2/5–2/8
D. Send request to three agencies	Carter	2/10
E. Meet with agency acct. execs	Lewis & Carter	2/16–2/20
3. A. Agencies work on proposals	Acct. Execs	2/23–5/1
B. Agencies present proposals	Carter	5/1–5/15
4. A. Select best proposal	Lewis	5/15–5/20
B. Meet with winning agency	Lewis	5/22–5/30
C. Inform losers	Carter	6/1
5. A. Fine-tune proposal	Acct. Exec	6/1–7/1
B. Presentation to management	Lewis	7/1–7/3
6. A. Ads air on TV	Lewis	9/1–12/24
B. Floor displays in stores	Carter	8/20–8/30
7. A. Gather recall measures of ads	Carter	9/1–12/24
B. Evaluate sales data	Carter	1/1–1/10
C. Prepare analysis of campaign	Carter	1/10–2/15

5. **Expected financial and physical consequences of each action:** Estimate when a completed ad campaign will be ready to show top management and how long it will take after approval to begin to air the ads. Estimate also the expected increase in store sales over the six-month period after the ads are first aired. Indicate whether "recall" measures will be used to help assess the ad campaign's effectiveness plus how, when, and by whom the recall data will be collected and analyzed.
6. **Contingency plans:** Indicate how long it will take to get an acceptable ad campaign to show top management if none of the initial proposals is acceptable.

Action plans are important for several reasons. First, action plans serve as a link between strategy formulation and evaluation and control. Second, the action plan specifies what needs to be done differently from the way operations are currently carried out. Third, during the evaluation and control process that comes later, an action plan helps in both the appraisal of performance and in the identification of any remedial actions, as needed. In addition, the explicit

assignment of responsibilities for implementing and monitoring the programs may contribute to better motivation.

MANAGEMENT BY OBJECTIVES

Management By Objectives (MBO) is a technique that encourages participative decision making through shared goal setting at all organizational levels and performance assessment based on the achievement of stated objectives.[86] MBO links organizational objectives and the behavior of individuals. Because it is a system that links plans with performance, it is a powerful implementation technique.

The MBO process involves:

1. Establishing and communicating organizational objectives.
2. Setting individual objectives (through superior-subordinate interaction) that help implement organizational ones.
3. Developing an action plan of activities needed to achieve the objectives.
4. Periodically (at least quarterly) reviewing performance as it relates to the objectives and including the results in the annual performance appraisal.[87]

MBO provides an opportunity for the corporation to connect the objectives of people at each level to those at the next higher level. MBO, therefore, acts to tie together corporate, business, and functional objectives, as well as the strategies developed to achieve them. Although MBO originated the 1950s, 90% of surveyed practicing managers feel that MBO is applicable today.[88] The principles of MBO are a part of self-managing work teams and quality circles.[89]

One of the real benefits of MBO is that it can reduce the amount of internal politics operating within a large corporation. Political actions within a firm can cause conflict and create divisions between the very people and groups who should be working together to implement strategy. People are less likely to jockey for position if the company's mission and objectives are clear and they know that the reward system is based not on game playing, but on achieving clearly communicated, measurable objectives.

TOTAL QUALITY MANAGEMENT

Total Quality Management (TQM) is an operational philosophy committed to *customer satisfaction* and *continuous improvement*. TQM is committed to quality/excellence and to being the best in all functions. Because TQM aims to reduce costs and improve quality, it can be used as a program to implement an overall low-cost or a differentiation business strategy. About 92% of manufacturing companies and 69% of service firms have implemented some form of quality management practices.[90] Not all TQM programs have been successes. Nevertheless, a recent survey of 325 manufacturing firms in Canada, Hungary, Italy, Lebanon, Taiwan, and the United States revealed that total quality management and just-in-time were the two highest-ranked improvement programs to improve company performance. This study agreed with a 2004 Census of Manufacturing survey that identified total quality management and lean manufacturing as the top improvement methodologies in both the U.S. and China.[91] An analysis of the successes and failures of TQM concluded that the key ingredient is top management. Successful TQM programs occur in those companies in which "top managers move beyond defensive and tactical orientations to embrace a developmental orientation."[92]

TQM has four objectives:

1. Better, less variable quality of the product and service
2. Quicker, less variable response in processes to customer needs

3. Greater flexibility in adjusting to customers' shifting requirements
4. Lower cost through quality improvement and elimination of non-value-adding work[93]

According to TQM, faulty processes, not poorly motivated employees, are the cause of defects in quality. The program involves a significant change in corporate culture, requiring strong leadership from top management, employee training, empowerment of lower-level employees (giving people more control over their work), and teamwork in order to succeed in a company. TQM emphasizes prevention, not correction. Inspection for quality still takes place, but the emphasis is on improving the process to prevent errors and deficiencies. Thus, quality circles or quality improvement teams are formed to identify problems and to suggest how to improve the processes that may be causing the problems.

TQM's essential ingredients are:

- **An intense focus on customer satisfaction:** Everyone (not just people in the sales and marketing departments) understands that their jobs exist only because of customer needs. Thus all jobs must be approached in terms of how they will affect customer satisfaction.
- **Internal as well as external customers:** An employee in the shipping department may be the internal customer of another employee who completes the assembly of a product, just as a person who buys the product is a customer of the entire company. An employee must be just as concerned with pleasing the internal customer as in satisfying the external customer.
- **Accurate measurement of every critical variable in a company's operations:** This means that employees have to be trained in what to measure, how to measure, and how to interpret the data. A rule of TQM is that *you only improve what you measure.*
- **Continuous improvement of products and services:** Everyone realizes that operations need to be continuously monitored to find ways to improve products and services.
- **New work relationships based on trust and teamwork:** Important is the idea of empowerment—giving employees wide latitude in how they go about achieving the company's goals. Research indicates that the keys to TQM success lie in executive commitment, an open organizational culture, and employee empowerment.[94]

INTERNATIONAL CONSIDERATIONS IN LEADING

In a study of 53 different national cultures, Hofstede found that each nation's unique culture could be identified using five dimensions. He found that national culture is so influential that it tends to overwhelm even a strong corporate culture. (See the numerous sociocultural societal variables that compose another country's culture that are listed in **Table 4–3**.) In measuring the differences among these **dimensions of national culture** from country to country, he was able to explain why a certain management practice might be successful in one nation but fail in another:[95]

1. **Power distance (PD)** is the extent to which a society accepts an unequal distribution of power in organizations. Malaysia and Mexico scored highest, whereas Germany and Austria scored lowest. People in those countries scoring high on this dimension tend to prefer autocratic to more participative managers.
2. **Uncertainty avoidance (UA)** is the extent to which a society feels threatened by uncertain and ambiguous situations. Greece and Japan scored highest on disliking ambiguity, whereas the United States and Singapore scored lowest. People in those nations scoring high on this dimension tend to want career stability, formal rules, and clear-cut measures of performance.
3. **Individualism-collectivism (I-C)** is the extent to which a society values individual freedom and independence of action compared with a tight social framework and loyalty to the group. The United States and Canada scored highest on individualism, whereas Mexico

and Guatemala scored lowest. People in nations scoring high on individualism tend to value individual success through competition, whereas people scoring low on individualism (thus high on collectivism) tend to value group success through collective cooperation.

4. **Masculinity-femininity (M-F)** is the extent to which society is oriented toward money and things (which Hofstede labels masculine) or toward people (which Hofstede labels feminine). Japan and Mexico scored highest on masculinity, whereas France and Sweden scored lowest (thus highest on femininity). People in nations scoring high on masculinity tend to value clearly defined sex roles where men dominate, and to emphasize performance and independence, whereas people scoring low on masculinity (and thus high on femininity) tend to value equality of the sexes where power is shared, and to emphasize the quality of life and interdependence.
5. **Long-term orientation (LT)** is the extent to which society is oriented toward the long- versus the short-term. Hong Kong and Japan scored highest on long-term orientation, whereas Pakistan scored the lowest. A long-term time orientation emphasizes the importance of hard work, education, and persistence as well as the importance of thrift. Nations with a long-term time orientation tend to value strategic planning and other management techniques with a long-term payback.

Hofstede's work was extended by Project GLOBE, a team of 150 researchers who collected data on cultural values and practices and leadership attributes from 18,000 managers in 62 countries. The project studied the nine cultural dimensions of assertiveness, future orientation, gender differentiation, uncertainty avoidance, power distance, institutional emphasis on collectivism versus individualism, in-group collectivism, performance orientation, and humane orientation.[96]

The dimensions of national culture help explain why some management practices work well in some countries but not in others. For example, MBO, which originated in the United States, succeeded in Germany, according to Hofstede, because the idea of replacing the arbitrary authority of the boss with the impersonal authority of mutually agreed-upon objectives fits the low power distance that is a dimension of the German culture. It failed in France, however, because the French are used to high power distances; they are used to accepting orders from a highly personalized authority. In countries with high levels of uncertainty avoidance, such as Switzerland and Austria, communication should be clear and explicit, based on facts. Meetings should be planned in advance and have clear agendas. In contrast, in low-uncertainty-avoidance countries such as Greece or Russia, people are not used to structured communication and prefer more open-ended meetings. Because Thailand has a high level of power distance, Thai managers feel that communication should go from the top to the bottom of a corporation. As a result, 360-degree performance appraisals are seen as dysfunctional.[97] Some of the difficulties experienced by U.S. companies in using Japanese-style quality circles in TQM may stem from the extremely high value U.S. culture places on individualism. The differences between the United States and Mexico in terms of the power distance (Mexico 104 vs. U.S. 46) and individualism-collectivism (U.S. 91 vs. Mexico 30) dimensions may help explain why some companies operating in both countries have difficulty adapting to the differences in customs.[98] In addition, research has found that technology alliance formation is strongest in countries that value cooperation and avoid uncertainty.[99]

When one successful company in one country merges with another successful company in another country, the clash of corporate cultures is compounded by the clash of national cultures. For example, when two companies, one from a high-uncertainty-avoidance society and one from a low-uncertainty-avoidance country, are considering a merger, they should investigate each other's management practices to determine potential areas of conflict. Given the growing number of cross-border mergers and acquisitions, the management of cultures is becoming a key issue in strategy implementation. See the **Global Issue** feature to learn how

differences in national and corporate cultures created conflict when Upjohn Company of the United States and Pharmacia AB of Sweden merged.

MNCs must pay attention to the many differences in cultural dimensions around the world and adjust their management practices accordingly. Cultural differences can easily go unrecognized by a headquarters staff that may interpret these differences as personality defects, whether the people in the subsidiaries are locals or expatriates. When conducting strategic planning in an MNC, top management must be aware that the process will vary based upon the national culture where a subsidiary is located. For example, in one MNC, the French expect concepts and key questions and answers. North American managers provide heavy financial analysis. Germans give precise dates and financial analysis. Information is usually late from Spanish and Moroccan operations and quotas are typically inflated. It is up to management to adapt to the differences.[100] The values embedded in his or her national culture have a profound and enduring effect on an executive's orientation, regardless of the impact of industry experience or corporate culture.[101] Hofstede and Bond conclude: "Whether they like it or not, the headquarters of multinationals are in the business of multicultural management."[102]

GLOBAL issue

CULTURAL DIFFERENCES CREATE IMPLEMENTATION PROBLEMS IN MERGER

When Upjohn Pharmaceuticals of Kalamazoo, Michigan, and Pharmacia AB of Stockholm, Sweden, merged in 1995, employees of both sides were optimistic for the newly formed Pharmacia & Upjohn, Inc. Both companies were second-tier competitors fighting for survival in a global industry. Together, the firms would create a global company that could compete scientifically with its bigger rivals.

Because Pharmacia had acquired an Italian firm in 1993, it also had a large operation in Milan. U.S. executives scheduled meetings throughout the summer of 1996—only to cancel them when their European counterparts could not attend. Although it was common knowledge in Europe that most Swedes take the entire month of July for vacation and that Italians take off all of August, this was not common knowledge in Michigan. Differences in management styles became a special irritant. Swedes were used to an open system, with autonomous work teams. Executives sought the whole group's approval before making an important decision. Upjohn executives followed the more traditional American top-down approach. Upon taking command of the newly merged firm, Dr. Zabriskie (who had been Upjohn's CEO), divided the company into departments reporting to the new London headquarters. He required frequent reports, budgets, and staffing updates. The Swedes reacted negatively to this top-down management hierarchical style. "It was degrading," said Stener Kvinnsland, head of Pharmacia's cancer research in Italy before he quit the new company.

The Italian operations baffled the Americans, even though the Italians felt comfortable with a hierarchical management style. Italy's laws and unions made layoffs difficult. Italian data and accounting were often inaccurate. Because the Americans didn't trust the data, they were constantly asking for verification. In turn, the Italians were concerned that the Americans were trying to take over Italian operations. At Upjohn, all workers were subject to testing for drug and alcohol abuse. Upjohn also banned smoking. At Pharmacia's Italian business center, however, waiters poured wine freely every afternoon in the company dining room. Pharmacia's boardrooms were stocked with humidors for executives who smoked cigars during long meetings. After a brief attempt to enforce Upjohn's policies, the company dropped both the no-drinking and no-smoking policies for European workers.

Although the combined company had cut annual costs by $200 million, overall costs of the merger reached $800 million, some $200 million more than projected. Nevertheless, Jan Eckberg, CEO of Pharmacia before the merger, remained confident of the new company's ability to succeed. He admitted, however, that "we have to make some smaller changes to release the full power of the two companies."

SOURCE: Summarized from R. Frank and T. M. Burton, "Cross-Border Merger Results in Headaches for a Drug Company," *Wall Street Journal* (February 4, 1997), pp. A1, A12.

End of Chapter SUMMARY

Strategy is implemented by modifying structure (organizing), selecting the appropriate people to carry out the strategy (staffing), and communicating clearly how the strategy can be put into action (leading). A number of programs, such as organizational and job design, reengineering, Six Sigma, MBO, TQM, and action planning, can be used to implement a new strategy. Executives must manage the corporate culture and find the right mix of qualified people to put a strategy in place.

Research on executive succession reveals that it is very risky to hire new top managers from outside the corporation. Although this is often done when a company is in trouble, it can be dangerous for a successful firm. This is also true when hiring people for non-executive positions. An in-depth study of 1,052 stock analysts at 78 investment banks revealed that hiring a star (an outstanding performer) from another company did not improve the hiring company's performance. When a company hires a star, the star's performance plunges, there is a sharp decline in the functioning of the team the person works with, and the company's market value declines. Their performance dropped about 20% and did not return to the level before the job change—even after five years. Interestingly, around 36% of the stars left the investment banks that hired them within 36 months. Another 29% quit in the next 24 months.

This phenomenon occurs not because a star doesn't suddenly become less intelligent when switching firms, but because the star cannot take to the new firm the firm-specific resources that contributed to her or his achievements at the previous company. As a result, the star is unable to repeat the high performance in another company until he/she learns the new system. This may take years, but only if the new company has a good support system in place. Otherwise, the performance may never improve. For these reasons, companies cannot obtain competitive advantage by hiring stars from the outside. Instead, they should emphasize growing their own talent and developing the infrastructure necessary for high performance.[103]

It is important to not ignore the 75% of the workforce who, while not being stars, are the solid performers that keep a company going over the years. An undue emphasis on attracting stars wastes money and destroys morale. The CEO of McKesson, a pharmaceutical wholesaler, calls these B players "performers in place. . . .They are happy living in Dubuque. I have more time and admiration for them than the A player who is at my desk every six months asking for the next promotion." Coaches who try to forge a sports team composed of stars court disaster. According to Karen Freeman, former head coach of women's basketball at Wake Forest University, "During my coaching days, the most dysfunctional teams were the ones who had no respect for the B players." In basketball or business, when the team goes into a slump, the stars are the first to whine, Freeman reports.[104]

ECO-BITS

- The U.S. Climate Action Partnership (USCAP), composed of General Electric, Caterpillar, Alcoa, General Motors, Chrysler, and Duke Energy plus 21 other major corporations, endorses reducing greenhouse gas emissions by 10% to 30% within 15 years and 60% to 80% by 2050 to avert the severest consequences of global warming.
- General Electric, Caterpillar, and Alcoa also sit on the board of the Center for Energy & Economic Development (CEED), an organization that opposes a federal climate bill requiring a 65% reduction in emissions by 2050.
- USCAP members General Motors and Chrysler are also members of the Heartland Institute, an organization that disputes humanity's role in global warming.
- Duke Energy, a USCAP member, is currently building two coal-burning power plants and also belongs to Americans for Balanced Energy Choices, a group that advocates expanded coal use.[105]

DISCUSSION QUESTIONS

1. What skills should a person have for managing a business unit following a differentiation strategy? Why? What should a company do if no one is available internally and the company has a policy of promotion from within?
2. When should someone from outside a company be hired to manage the company or one of its business units?
3. What are some ways to implement a retrenchment strategy without creating a lot of resentment and conflict with labor unions?
4. How can corporate culture be changed?
5. Why is an understanding of national cultures important in strategic management?

STRATEGIC PRACTICE EXERCISE

Staffing involves finding the person with the right blend of characteristics, such as personality, training, and experience, to implement a particular strategy. The Keirsey Temperament Sorter is designed to identify different kinds of personality temperament. It is similar to other instruments derived from Carl Jung's theory of psychological types, such as the Myers-Briggs, the Singer-Loomis, and the Grey-Wheelright. The questionnaire identifies four temperament types: **Guardian (SJ), Artisan (SP), Idealist (NF), and Rational (NT)**. ***Guardians*** have natural talent in managing goods and services. They are dependable and trustworthy. ***Artisans*** have keen senses and are at home with tools, instruments, and vehicles. They are risk-takers and like action. ***Idealists*** are concerned with growth and development and like to work with people. They prefer friendly cooperation over confrontation and conflict. ***Rationalists*** are problem solvers who like to know how things work. They work tirelessly to accomplish their goals. Each of these four types has four variants.[106]

Keirsey challenges the assumption that people are basically the same in the ways that they think, feel, and approach problems. Keirsey argues that it is far less desirable to attempt to change others (because it has little likelihood of success) than to attempt to understand, work with, and take advantage of normal differences. Companies can use this type of questionnaire to help team members understand how each person can contribute to team performance. For example, Lucent Technology used the Myers-Briggs Type Indicator to help build trust and understanding among 500 engineers in 13 time zones and three continents in a distributed development project.

1. Access the Keirsey Temperament Sorter using your Internet browser. Type in the following URL: **www.advisorteam.com**
2. Complete and score the questionnaire. Print the description of your personality type.
3. Read the information on the Web site about each personality type. Become familiar with each.
4. Bring to class a sheet of paper containing your name and your personality type: *Guardian*, *Artisan*, *Idealist*, or *Rational*. Your instructor will either put you into a group containing people with the same predominant style or into a group with representatives from each type. He or she may then give each group a number. The instructor will then give the teams a task to accomplish. Each group will have approximately 30 minutes to do the task. It may be to solve a problem, analyze a short case, or propose a new entrepreneurial venture. The instructor will provide you with very little guidance other than to form and number the groups, give them a task, and keep track of time. He or she may move from group to group to sit in on each team's progress. When the time is up, the instructor will ask a spokesperson from each group to (1) describe the process the group went through and (2) present orally each group's ideas. After each group makes its presentation, the instructor may choose one or more of the following:
   - On a sheet of paper, each person in the class identifies his/her personality type and votes which team did the best on the assignment.
   - The class as a whole tries to identify each group's dominant decision-making style in terms of how they did their assignment. See how many people vote for one of the four types for each team.
   - Each member of a group guesses if she/he was put into a team composed of the same personality types or in one composed of all four personality types.

KEY TERMS

action plan (p. 316)
dimensions of national culture (p. 319)
downsizing (p. 308)
executive succession (p. 305)
executive type (p. 304)
individualism-collectivism (I-C) (p. 319)
integration manager (p. 303)
leading (p. 302)
long-term orientation (LT) (p. 320)
Management By Objectives (MBO) (p. 318)
masculinity-femininity (M-F) (p. 320)
power distance (PD) (p. 319)
staffing (p. 302)
Total Quality Management (TQM) (p. 318)
uncertainty avoidance (UA) (p. 319)

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CHAPTER 11

evaluation and Control

Nucor Corporation, one of the most successful steel firms operating in the United States, keeps its evaluation and control process simple and easy to manage. According to Kenneth Iverson, Chairman of the Board:

> We try to keep our focus on what really matters—bottom-line performance and long-term survival. That's what we want our people to be thinking about. Management takes care not to distract the company with a lot of talk about other issues. We don't clutter the picture with lofty vision statements or ask employees to pursue vague, intermediate objectives such as "excellence" or burden them with complex business strategies. Our competitive strategy is to build manufacturing facilities economically and to operate them efficiently. Period. Basically, we ask our employees to produce more product for less money. Then we reward them for doing that well.[1]

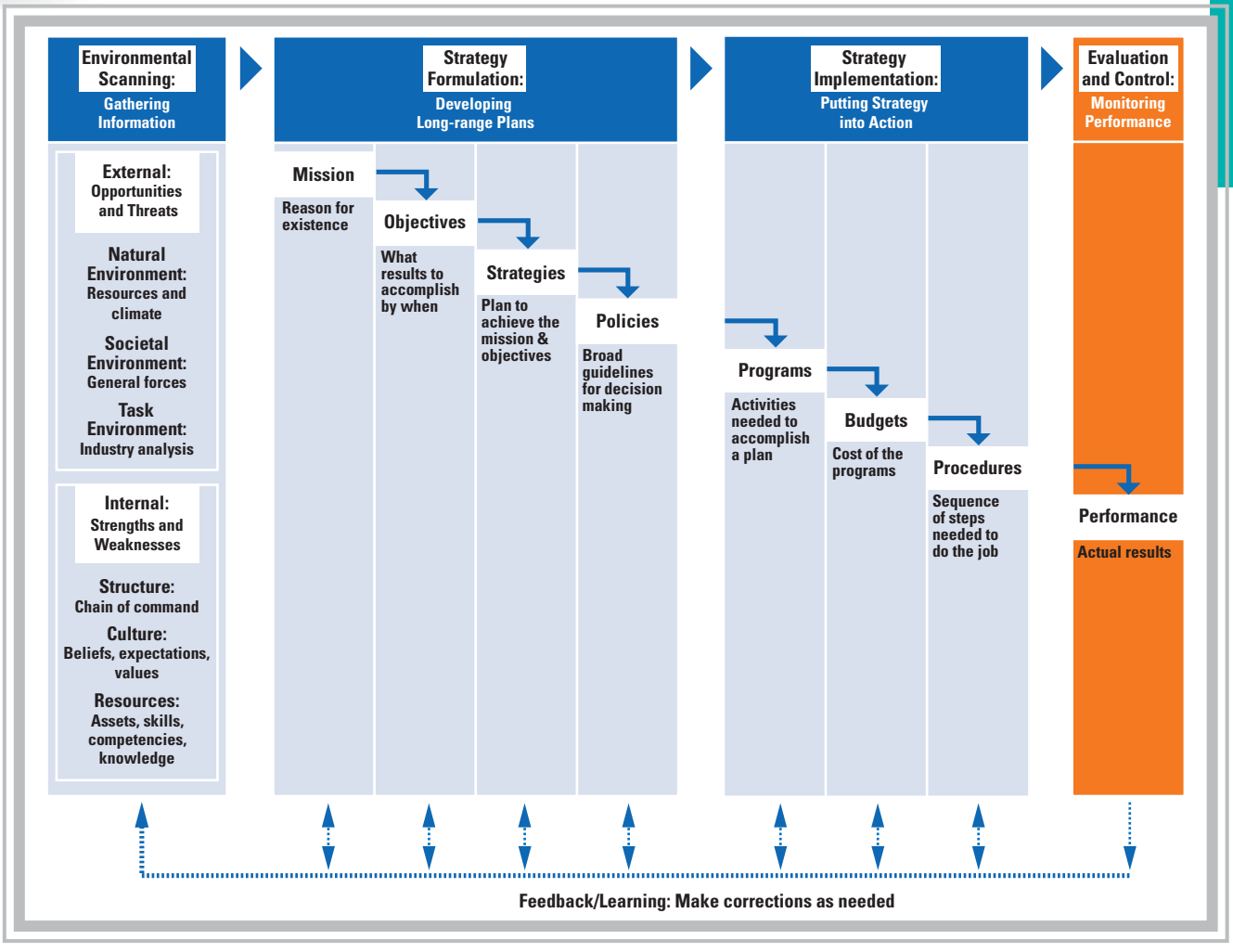
The **evaluation and control process** ensures that a company is achieving what it set out to accomplish. It compares performance with desired results and provides the feedback necessary for management to evaluate results and take corrective action, as needed. This process can be viewed as a five-step feedback model, as depicted in **Figure 11–1.**

1. **Determine what to measure:** Top managers and operational managers need to specify what implementation processes and results will be monitored and evaluated. The processes and results must be capable of being measured in a reasonably objective and consistent manner. The focus should be on the most significant elements in a process—the ones that account for the highest proportion of expense or the greatest number of problems. Measurements must be found for all important areas, regardless of difficulty.
2. **Establish standards of performance:** Standards used to measure performance are detailed expressions of strategic objectives. They are measures of acceptable performance results. Each standard usually includes a tolerance range, which defines acceptable deviations. Standards can be set not only for final output but also for intermediate stages of production output.
3. **Measure actual performance:** Measurements must be made at predetermined times.
4. **Compare actual performance with the standard:** If actual performance results are within the desired tolerance range, the measurement process stops here.

Learning Objectives

After reading this chapter, you should be able to:

- Understand the basic control process
- Choose among traditional measures, such as ROI, and shareholder value measures, such as economic value added, to properly assess performance
- Use the balanced scorecard approach to develop key performance measures
- Apply the benchmarking process to a function or an activity
- Understand the impact of problems with measuring performance
- Develop appropriate control systems to support specific strategies



5. **Take corrective action:** If actual results fall outside the desired tolerance range, action must be taken to correct the deviation. The following questions must be answered:
   a. Is the deviation only a chance fluctuation?
   b. Are the processes being carried out incorrectly?
   c. Are the processes appropriate to the achievement of the desired standard? Action must be taken that will not only correct the deviation but also prevent its happening again.
   d. Who is the best person to take corrective action?

Top management is often better at the first two steps of the control model than it is at the last two follow-through steps. It tends to establish a control system and then delegate the implementation to others. This can have unfortunate results. Nucor is unusual in its ability to deal with the entire evaluation and control process.

11.1 Evaluation and Control in Strategic Management

Evaluation and control information consists of performance data and activity reports (gathered in Step 3 in **Figure 11–1**). If undesired performance results because the strategic management processes were inappropriately used, operational managers must know about it so that they can correct the employee activity. Top management need not be involved. If, however, undesired performance results from the processes themselves, top managers, as well as operational managers, must know about it so that they can develop new implementation programs or procedures. Evaluation and control information must be relevant to what is being monitored. One of the obstacles to effective control is the difficulty in developing appropriate measures of important activities and outputs.

An application of the control process to strategic management is depicted in **Figure 11–2.** It provides strategic managers with a series of questions to use in evaluating an implemented strategy. Such a strategy review is usually initiated when a gap appears between a company's financial objectives and the expected results of current activities. After answering the proposed set of questions, a manager should have a good idea of where the problem originated and what must be done to correct the situation.

FIGURE 11–1
Evaluation and Control Process

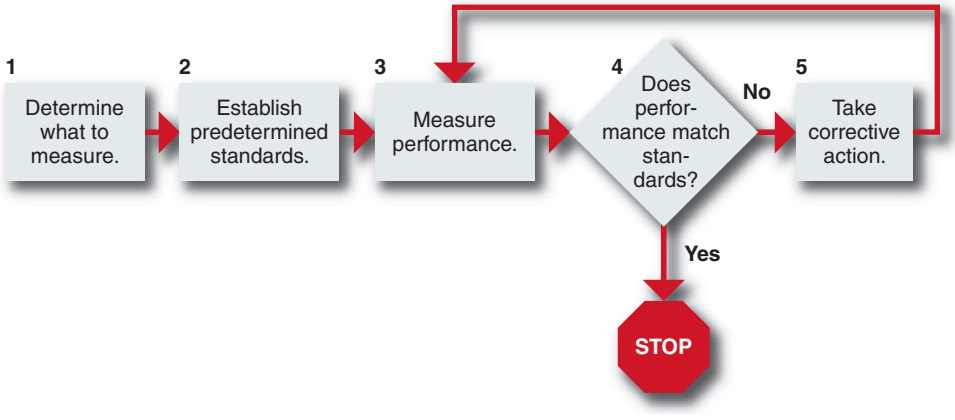
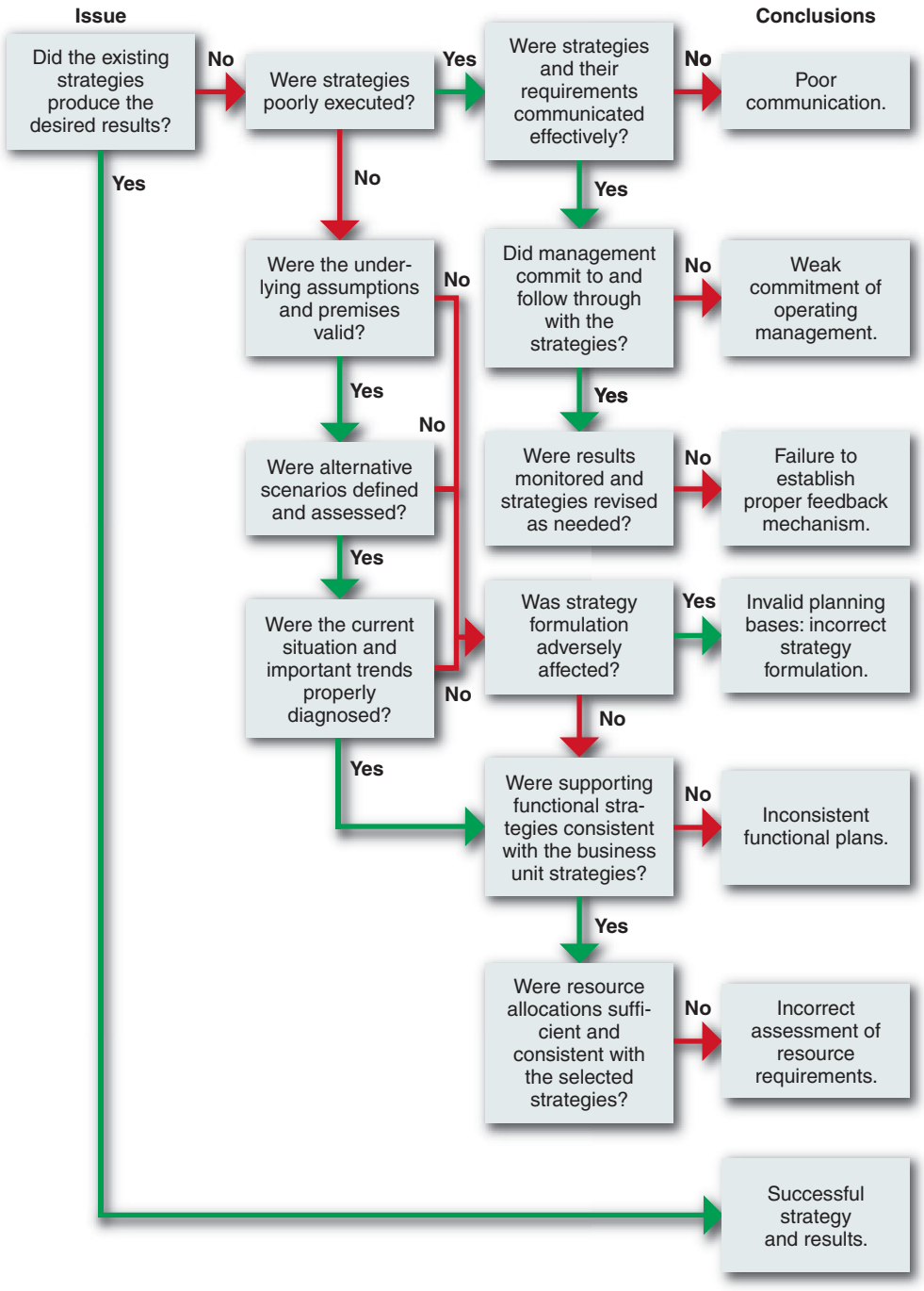


FIGURE 11–2
Evaluating an Implemented Strategy



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11.2 Measuring Performance

Performance is the end result of activity. Select measures to assess performance based on the organizational unit to be appraised and the objectives to be achieved. The objectives that were established earlier in the strategy formulation part of the strategic management process (dealing with profitability, market share, and cost reduction, among others) should certainly be used to measure corporate performance once the strategies have been implemented.

APPROPRIATE MEASURES

Some measures, such as return on investment (ROI) and earnings per share (EPS), are appropriate for evaluating a corporation's or a division's ability to achieve a profitability objective. This type of measure, however, is inadequate for evaluating additional corporate objectives such as social responsibility or employee development. Even though profitability is a corporation's major objective, ROI and EPS can be computed only after profits are totaled for a period. It tells what happened after the fact—not what is happening or what will happen. A firm, therefore, needs to develop measures that predict likely profitability. These are referred to as **steering controls** because they measure variables that influence future profitability. Every industry has its own set of key metrics which tend to predict profits. Airlines, for example, closely monitor cost per passenger mile. In the 1990s, Southwest's cost per passenger mile was 6.43¢, the lowest in the industry, contrasted with American's 12.95¢, the highest in the industry.[2] Its low costs gave Southwest a significant competitive advantage.

An example of a steering control used by retail stores is the *inventory turnover ratio*, in which a retailer's cost of goods sold is divided by the average value of its inventories. This measure shows how hard an investment in inventory is working; the higher the ratio, the better. Not only does quicker moving inventory tie up less cash in inventories, it also reduces the risk that the goods will grow obsolete before they're sold—a crucial measure for computers and other technology items. For example, Office Depot increased its inventory turnover ratio from 6.9 in one year to 7.5 the next year, leading to improved annual profits.[3]

Another steering control is customer satisfaction. Research reveals that companies that score high on the *American Customer Satisfaction Index (ACSI)*, a measure developed by the University of Michigan's National Research Center, have higher stock returns and better cash flows than do those companies that score low on the ACSI. A change in a firm's customer satisfaction typically works its way through a firm's value chain and is eventually reflected in quarterly profits.[4] Other approaches to measuring customer satisfaction include Oracle's use of the ratio of quarterly sales divided by customer service requests and the total number of hours that technicians spend on the phone solving customer problems. To help executives keep track of important steering controls, Netsuite developed *dashboard* software that displays critical information in easy-to-read computer graphics assembled from data pulled from other corporate software programs.[5]

TYPES OF CONTROLS

Controls can be established to focus on actual performance results (output), the activities that generate the performance (behavior), or on resources that are used in performance (input). **Output controls** specify what is to be accomplished by focusing on the end result of the behaviors through the use of objectives and performance targets or milestones. **Behavior controls** specify how something is to be done through policies, rules, standard operating

procedures, and orders from a superior. **Input controls** emphasize resources, such as knowledge, skills, abilities, values, and motives of employees.[6]

Output, behavior, and input controls are not interchangeable. Output controls (such as sales quotas, specific cost-reduction or profit objectives, and surveys of customer satisfaction) are most appropriate when specific output measures have been agreed on but the cause–effect connection between activities and results is not clear. Behavior controls (such as following company procedures, making sales calls to potential customers, and getting to work on time) are most appropriate when performance results are hard to measure, but the cause–effect connection between activities and results is clear. Input controls (such as number of years of education and experience) are most appropriate when output is difficult to measure and there is no clear cause–effect relationship between behavior and performance (such as in college teaching). Corporations following the strategy of conglomerate diversification tend to emphasize output controls with their divisions and subsidiaries (presumably because they are managed independently of each other), whereas, corporations following concentric diversification use all three types of controls (presumably because synergy is desired).[7] Even if all three types of control are used, one or two of them may be emphasized more than another depending on the circumstances. For example, Muralidharan and Hamilton propose that as a multinational corporation moves through its stages of development, its emphasis on control should shift from being primarily output at first, to behavioral, and finally to input control.[8]

Examples of increasingly popular behavior controls are the ISO 9000 and 14000 Standards Series on quality and environmental assurance, developed by the International Standards Association of Geneva, Switzerland. Using the **ISO 9000 Standards Series** (composed of five sections from 9000 to 9004) is a way of objectively documenting a company's high level of quality operations. Using the **ISO 14000 Standards Series** is a way to document the company's impact on the environment. A company wanting ISO 9000 certification would document its process for product introductions, among other things. ISO 9001 would require this firm to separately document design input, design process, design output, and design verification—a large amount of work. ISO 14001 would specify how companies should establish, maintain and continually improve an environmental management system. Although the average total cost for a company to be ISO 9000 certified is close to $250,000, the annual savings are around $175,000 per company.[9] Overall, ISO 14001-related savings are about equal to the costs, reports Tim Delawder, Vice President of SWD, Inc., a metal finishing company in Addison, Illinois.[10]

Many corporations view ISO 9000 certification as assurance that a supplier sells quality products. Firms such as DuPont, Hewlett-Packard, and 3M have facilities registered to ISO standards. Companies in more than 60 countries, including Canada, Mexico, Japan, the United States (including the entire U.S. auto industry), and the European Union, require ISO 9000 certification of their suppliers.[11] The same is happening for ISO 14000. Both Ford and General Motors require their suppliers to follow ISO 14001. In a survey of manufacturing executives, 51% of the executives found that ISO 9000 certification increased their international competitiveness. Other executives noted that it signaled their commitment to quality and gave them a strategic advantage over noncertified competitors.[12]

Since its ISO 14000 certification, SWD Inc. has become a showplace for environmental awareness. According to SWD's Delawder, ISO 14000 certification improves environmental awareness among employees, reduces risks of violating regulations, and improves the firm's image among customers and the local community.[13]

Another example of a behavior control is a company's monitoring of employee phone calls and PCs to ensure that employees are behaving according to company guidelines. In a study by the American Management Association, nearly 75% of U.S. companies actively monitored their workers' communications and on-the-job activities. Around 54% tracked individual

employees' Internet connections and 38% admitted storing and reviewing their employees' e-mail. About 45% of the companies surveyed had disciplined workers (16% had fired them). For example, Xerox fired 40 employees for visiting pornographic Web sites.[14]

ACTIVITY-BASED COSTING

Activity-based costing (ABC) is a recently developed accounting method for allocating indirect and fixed costs to individual products or product lines based on the value-added activities going into that product.[15] This accounting method is thus very useful in doing a value-chain analysis of a firm's activities for making outsourcing decisions. Traditional cost accounting, in contrast, focuses on valuing a company's inventory for financial reporting purposes. To obtain a unit's cost, cost accountants typically add direct labor to the cost of materials. Then they compute overhead from rent to R&D expenses, based on the number of direct labor hours it takes to make a product. To obtain unit cost, they divide the total by the number of items made during the period under consideration.

Traditional cost accounting is useful when direct labor accounts for most of total costs and a company produces just a few products requiring the same processes. This may have been true of companies during the early part of the twentieth century, but it is no longer relevant today, when overhead may account for as much as 70% of manufacturing costs. According to Bob Van Der Linde, CEO of a contract manufacturing services firm in San Diego, California: "Overhead is 80% to 90% in our industry, so allocation errors lead to pricing errors, which could easily bankrupt the company."[16] The appropriate allocation of indirect costs and overhead has thus become crucial for decision making. The traditional volume-based cost-driven system systematically understates the cost per unit of products with low sales volumes and products with a high degree of complexity. Similarly, it overstates the cost per unit of products with high sales volumes and a low degree of complexity.[17] When Chrysler used ABC, it discovered that the true cost of some of the parts used in making cars was 30 times what the company had previously estimated.[18]

ABC accounting allows accountants to charge costs more accurately than the traditional method because it allocates overhead far more precisely. For example, imagine a production line in a pen factory where black pens are made in high volume and blue pens in low volume. Assume that it takes eight hours to retool (reprogram the machinery) to shift production from one kind of pen to the other. The total costs include supplies (the same for both pens), the direct labor of the line workers, and factory overhead. In this instance, a very significant part of the overhead cost is the cost of reprogramming the machinery to switch from one pen to another. If the company produces 10 times as many black pens as blue pens, 10 times the cost of the reprogramming expenses will be allocated to the black pens as to the blue pens under traditional cost accounting methods. This approach underestimates, however, the true cost of making the blue pens.

ABC accounting, in contrast, first breaks down pen manufacturing into its activities. It is then very easy to see that it is the activity of changing pens that triggers the cost of retooling. The ABC accountant calculates an average cost of setting up the machinery and charges it against each batch of pens that requires retooling, regardless of the size of the run. Thus a product carries only those costs for the overhead it actually consumes. Management is now able to discover that its blue pens cost almost twice as much as do the black pens. Unless the company is able to charge a higher price for its blue pens, it cannot make a profit on these pens. Unless there is a strategic reason why it must offer blue pens (such as a key customer who must have a small number of blue pens with every large order of black pens or a marketing trend away from black to blue pens), the company will earn significantly greater profits if it completely stops making blue pens.[19]

ENTERPRISE RISK MANAGEMENT

Enterprise Risk Management (ERM) is a corporatewide, integrated process for managing the uncertainties that could negatively or positively influence the achievement of the corporation's objectives. In the past, managing risk was done in a fragmented manner within functions or business units. Individuals would manage process risk, safety risk, and insurance, financial, and other assorted risks. As a result of this fragmented approach, companies would take huge risks in some areas of the business while over-managing substantially smaller risks in other areas. ERM is being adopted because of the increasing amount of environmental uncertainty that can affect an entire corporation. As a result, the position Chief Risk Officer is one of the fastest growing executive positions in U.S. corporations.[20] Microsoft uses scenario analysis to identify key business risks. According to Microsoft's treasurer, Brent Callinicos, "The scenarios are really what we're trying to protect against."[21] The scenarios were the possibility of an earthquake in the Seattle region and a major downturn in the stock market.

The process of rating risks involves three steps:

1. Identify the risks using scenario analysis or brainstorming or by performing risk self-assessments.
2. Rank the risks, using some scale of impact and likelihood.
3. Measure the risks, using some agreed-upon standard.

Some companies are using value at risk, or VAR (effect of unlikely events in normal markets), and stress testing (effect of plausible events in abnormal markets) methodologies to measure the potential impact of the financial risks they face. DuPont uses earnings at risk (EAR) measuring tools to measure the effect of risk on reported earnings. It can then manage risk to a specified earnings level based on the company's "risk appetite." With this integrated view, DuPont can view how risks affect the likelihood of achieving certain earnings targets.[22] Research has shown that companies with integrative risk management capabilities achieve superior economic performance.[23]

PRIMARY MEASURES OF CORPORATE PERFORMANCE

The days when simple financial measures such as ROI or EPS were used alone to assess overall corporate performance are coming to an end. Analysts now recommend a broad range of methods to evaluate the success or failure of a strategy. Some of these methods are stakeholder measures, shareholder value, and the balanced scorecard approach. Even though each of these methods has supporters as well as detractors, the current trend is clearly toward more complicated financial measures and an increasing use of non-financial measures of corporate performance. For example, research indicates that companies pursuing strategies founded on innovation and new product development now tend to favor non-financial over financial measures.[24]

Traditional Financial Measures

The most commonly used measure of corporate performance (in terms of profits) is **Return On Investment (ROI).** It is simply the result of dividing net income before taxes by the total amount invested in the company (typically measured by total assets). Although using ROI has several advantages, it also has several distinct limitations. (See **Table 11–1**.) Although ROI gives the impression of objectivity and precision, it can be easily manipulated.

Earnings Per Share (EPS), which involves dividing net earnings by the amount of common stock, also has several deficiencies as an evaluation of past and future performance. First, because alternative accounting principles are available, EPS can have several different but

TABLE 11–1

Advantages and Limitations of Using ROI as a Measure of Corporate Performance

Before using Return on Investment (ROI) as a measure of corporate performance, consider its advantages and limitations.

Advantages

- ROI is a single, comprehensive number that includes all revenues, costs, and expenses.
- It can be used to evaluate the performance of a general manager of a division or SBU.
- It can be compared across companies to see which firms are performing better.
- It provides an incentive to use current assets efficiently and to acquire new assets only when they would increase profits significantly.

Limitations

- ROI is very sensitive to depreciation policy. ROI can be increased by writing down the value of assets through accelerated depreciation.
- It can discourage investment in new facilities or the upgrading of old ones. Older plants with depreciated assets have an advantage over newer plants in earning a higher ROI.
- It provides an incentive for division managers to set transfer prices for goods sold to other divisions as high as possible and to lobby for corporate policy favoring in-house transfers over purchases from other firms.
- Managers tend to focus more on ROI in the short-run over its use in the long-run. This provides an incentive for goal displacement and other dysfunctional consequences.
- ROI is not comparable across industries which operate under different conditions of favorability.
- It is influenced by the overall economy and will tend to be higher in prosperity and lower in a recession.

SOURCE: From Higgins. Organizational Policy and Strategic Management, 2nd edition, © 1983 South-Western, a part of Cengage Learning, Inc. Reproduced by permission. www.cengage.com/permissions

equally acceptable values, depending on the principle selected for its computation. Second, because EPS is based on accrual income, the conversion of income to cash can be near term or delayed. Therefore, EPS does not consider the time value of money. **Return On Equity (ROE)**, which involves dividing net income by total equity, also has limitations because it is also derived from accounting-based data. In addition, EPS and ROE are often unrelated to a company's stock price.

Operating cash flow, the amount of money generated by a company before the cost of financing and taxes, is a broad measure of a company's funds. This is the company's net income plus depreciation, depletion, amortization, interest expense, and income tax expense.[25] Some takeover specialists look at a much narrower **free cash flow**: the amount of money a new owner can take out of the firm without harming the business. This is net income plus depreciation, depletion, and amortization less capital expenditures and dividends. The free cash flow ratio is very useful in evaluating the stability of an entrepreneurial venture.[26] Although cash flow may be harder to manipulate than earnings, the number can be increased by selling accounts receivable, classifying outstanding checks as accounts payable, trading securities, and capitalizing certain expenses, such as direct-response advertising.[27]

Because of these and other limitations, ROI, EPS, ROE, and operating cash flow are not by themselves adequate measures of corporate performance. At the same time, these traditional financial measures are very appropriate when used with complementary financial and non-financial measures. For example, some non–financial performance measures often used by Internet business ventures are *stickiness* (length of Web site visit), *eyeballs* (number of people who visit a Web site), and *mindshare* (brand awareness). Mergers and acquisitions may be priced on multiples of *MUUs* (monthly unique users) or even on registered users.

TABLE 11–2 A Sample Scorecard for "Keeping Score" with Stakeholders

Stakeholder Category	Possible Near-Term Measures	Possible Long-Term Measures
Customers	Sales ($ and volume) New customers Number of new customer needs met ("tries")	Growth in sales Turnover of customer base Ability to control price
Suppliers	Cost of raw material Delivery time Inventory Availability of raw material	Growth rates of: Raw material costs Delivery time Inventory New ideas from suppliers
Financial community	EPS Stock price Number of "buy" lists ROE	Ability to convince Wall Street of strategy Growth in ROE
Employees	Number of suggestions Productivity Number of grievances	Number of internal promotions Turnover
Congress	Number of new pieces of legislation that affect the firm Access to key members and staff	Number of new regulations that affect industry Ratio of "cooperative" vs. "competitive" encounters
Consumer advocate (CA)	Number of meetings Number of "hostile" encounters Number of times coalitions formed Number of legal actions	Number of changes in policy due to CA Number of CA-initiated "calls for help"
Environmentalists	Number of meetings Number of hostile encounters Number of times coalitions formed Number of EPA complaints Number of legal actions	Number of changes in policy due to environmentalists Number of environmentalist "calls for help"

SOURCE: R. E. Freeman, *Strategic Management: A Stakeholder Approach* (Boston: Ballinger Publishing Company, 1984), p. 179. Copyright © 1984 by R. E. Freeman. Reprinted by permission of R. Edward Freeman.

Stakeholder Measures

Each stakeholder has its own set of criteria to determine how well the corporation is performing. These criteria typically deal with the direct and indirect impacts of corporate activities on stakeholder interests. Top management should establish one or more stakeholder measures for each stakeholder category so that it can keep track of stakeholder concerns. (See **Table 11–2**.)

Shareholder Value

Because of the belief that accounting-based numbers such as ROI, ROE, and EPS are not reliable indicators of a corporation's economic value, many corporations are using shareholder value as a better measure of corporate performance and strategic management effectiveness.

Shareholder value can be defined as the present value of the anticipated future stream of cash flows from the business plus the value of the company if liquidated. Arguing that the purpose of a company is to increase shareholder wealth, shareholder value analysis concentrates on cash flow as the key measure of performance. The value of a corporation is thus the value of its cash flows discounted back to their present value, using the business's cost of capital as

the discount rate. As long as the returns from a business exceed its cost of capital, the business will create value and be worth more than the capital invested in it. For example, Deere and Company charges each business unit a cost of capital of 1% of assets a month. Each business unit is required to earn a shareholder value-added profit margin of 20% on average over the business cycle. Financial rewards are linked to this measure.[28]

The New York consulting firm Stern Stewart & Company devised and popularized two shareholder value measures: economic value added (EVA) and market value added (MVA). A basic tenet of EVA and MVA is that businesses should not invest in projects unless they can generate a profit above the cost of capital. Stern Stewart argues that a deficiency of traditional accounting-based measures is that they assume the cost of capital to be zero.[29] Well-known companies, such as Coca-Cola, General Electric, AT&T, Whirlpool, Quaker Oats, Eli Lilly, Georgia-Pacific, Polaroid, Sprint, Teledyne, and Tenneco have adopted MVA and/or EVA as the best yardstick for corporate performance.

Economic Value Added (EVA) has become an extremely popular shareholder value method of measuring corporate and divisional performance and may be on its way to replacing ROI as the standard performance measure. EVA measures the difference between the pre-strategy and post-strategy values for the business. Simply put, EVA is after-tax operating income minus the total annual cost of capital. The formula to measure EVA is:

$$\text{EVA} = \text{after tax operating income} - (\text{investment in assets} \times \text{weighted average cost of capital})$$[30]

The cost of capital combines the cost of debt and equity. The annual cost of borrowed capital is the interest charged by the firm's banks and bondholders. To calculate the cost of equity, assume that shareholders generally earn about 6% more on stocks than on government bonds. If long-term treasury bills are selling at 7.5%, the firm's cost of equity should be 13.5%—more if the firm is in a risky industry. A corporation's overall cost of capital is the weighted-average cost of the firm's debt and equity capital. The investment in assets is the total amount of capital invested in the business, including buildings, machines, computers, and investments in R&D and training (allocating costs annually over their useful life). Because the typical balance sheet understates the investment made in a company, Stern Stewart has identified 150 possible adjustments, before EVA is calculated.[31] Multiply the firm's total investment in assets by the weighted-average cost of capital. Subtract that figure from after-tax operating income. If the difference is positive, the strategy (and the management employing it) is generating value for the shareholders. If it is negative, the strategy is destroying shareholder value.[32]

Roberto Goizueta, past-CEO of Coca-Cola, explained, "We raise capital to make concentrate, and sell it at an operating profit. Then we pay the cost of that capital. Shareholders pocket the difference."[33] Managers can improve their company's or business unit's EVA by: (1) earning more profit without using more capital, (2) using less capital, and (3) investing capital in high-return projects. Studies have found that companies using EVA outperform their median competitor by an average of 8.43% of total return annually.[34] EVA does, however, have some limitations. For one thing, it does not control for size differences across plants or divisions. As with ROI, managers can manipulate the numbers. As with ROI, EVA is an after-the-fact measure and cannot be used like a steering control.[35] Although proponents of EVA argue that EVA (unlike Return on Investment, Equity, or Sales) has a strong relationship to stock price, other studies do not support this contention.[36]

Market Value Added (MVA) is the difference between the market value of a corporation and the capital contributed by shareholders and lenders. Like net present value, it measures the stock market's estimate of the net present value of a firm's past and expected capital investment projects. As such, MVA is the present value of future EVA.[37] To calculate MVA,

1. Add all the capital that has been put into a company—from shareholders, bondholders, and retained earnings.

2. Reclassify certain accounting expenses, such as R&D, to reflect that they are actually investments in future earnings. This provides the firm's total capital. So far, this is the same approach taken in calculating EVA.
3. Using the current stock price, total the value of all outstanding stock, adding it to the company's debt. This is the company's market value. If the company's market value is greater than all the capital invested in it, the firm has a positive MVA—meaning that management (and the strategy it is following) has created wealth. In some cases, however, the market value of the company is actually less than the capital put into it, which means shareholder wealth is being destroyed.

Microsoft, General Electric, Intel, and Coca-Cola have tended to have high MVAs in the United States, whereas, General Motors and RJR Nabisco have had low ones.[38] Studies have shown that EVA is a predictor of MVA. Consecutive years of positive EVA generally lead to a soaring MVA.[39] Research also reveals that CEO turnover is significantly correlated with MVA and EVA, whereas ROA and ROE are not. This suggests that EVA and MVA may be more appropriate measures of the market's evaluation of a firm's strategy and its management than are the traditional measures of corporate performance.[40] Nevertheless, these measures consider only the financial interests of the shareholder and ignore other stakeholders, such as environmentalists and employees.

Climate change is likely to lead to new regulations, technological remedies, and shifts in consumer behavior. It will thus have a significant impact on the financial performance of many corporations. To learn how global warming is likely to affect different industrial sectors and corporations, see the **Environmental Sustainability Issue** feature.

Balanced Scorecard Approach: Using Key Performance Measures

Rather than evaluate a corporation using a few financial measures, Kaplan and Norton argue for a "balanced scorecard," that includes non-financial as well as financial measures.[41] This approach is especially useful given that research indicates that non-financial assets explain 50% to 80% of a firm's value.[42] The **balanced scorecard** combines financial measures that tell the results of actions already taken with operational measures on customer satisfaction, internal processes, and the corporation's innovation and improvement activities—the drivers of future financial performance. Thus steering controls are combined with output controls. In the balanced scorecard, management develops goals or objectives in each of four areas:

1. **Financial:** How do we appear to shareholders?
2. **Customer:** How do customers view us?
3. **Internal business perspective:** What must we excel at?
4. **Innovation and learning:** Can we continue to improve and create value?[43]

Each goal in each area (for example, avoiding bankruptcy in the financial area) is then assigned one or more measures, as well as a target and an initiative. These measures can be thought of as **key performance measures**—measures that are essential for achieving a desired strategic option.[44] For example, a company could include cash flow, quarterly sales growth, and ROE as measures for success in the financial area. It could include market share (competitive position goal), customer satisfaction, and percentage of new sales coming from new products (customer acceptance goal) as measures under the customer perspective. It could include cycle time and unit cost (manufacturing excellence goal) as measures under the internal business perspective. It could include time to develop next generation products (technology leadership objective) under the innovation and learning perspective.

ENVIRONMENTAL sustainability issue

HOW GLOBAL WARMING COULD AFFECT CORPORATE VALUATION

How will global warming affect the value of a corporation's stock? To answer this question, the U.S.-based consulting firm McKinsey & Company undertook a joint project with the Carbon Trust, a UK research organization. The resulting research found that the large reductions in greenhouse gas emissions needed to stop climate change will create significant opportunities and risks for most companies. Well-positioned, forward-thinking corporations could, for example, increase company value (stock price × number of shares outstanding) by up to 80%. The research found that as much as 65% of company value was at risk in some industrial sectors.

Industrial Sector	Maximum Company Value Creation Opportunity for Prepared Company	Maximum Company Value at Risk for a Company Failing to Adapt
Aluminum	30%	65%
Automotive	60%	65%
Oil & Gas (Exploration & Production)	0%	35%
Oil & Gas (Refining)	7%	30%
Consumer Electronics	35%	7%
Building Materials	80%	20%
Beer	0%	15%

The joint study investigated the industrial sectors of aluminum, automotive, oil and gas, consumer electronics, building materials, and beer. It quantified the impacts on each industrial sector and found that the impact of climate change will vary by sector. The resulting report lists both the maximum value creation opportunity for a prepared company and the maximum company value at risk for a company that fails to adapt.

Note that the oil and gas sectors will have very few opportunities (especially in exploration and production), but many risks. This overall negative impact will mean falling cash flows and stock prices for the companies in those sectors. In contrast, the building materials sector will benefit from rising demand for improved energy efficiency and insulation products, leading to increasing cash flows and stock prices. The consumer electronics sector is also in a good position. Using current technology, consumer electronics companies can make their products significantly more energy efficient (by reducing active and standby power consumption) at low and diminishing costs. Automobile companies, in contrast, face both a high level of opportunities and threats. The better prepared companies should do well, but the laggards will likely face serious cash flow problems and falling stock prices.

Tom Delay, Carbon Trust's CEO warns: "We have a short window of opportunity to act but at present business and investor actions are way out of step with the need to tackle climate change. They must be urgently re-aligned by developing new business and investment strategies and by working with governments to develop policy frameworks that reward early and effective action to rapidly reduce carbon emissions."

SOURCES: M. W. Brinkman, N. Hoffman, J. M. Oppenheim, "How Climate Change Could Affect Corporate Valuations," *McKinsey Quarterly* (Autumn 2008), pp. 1–7; "Climate Change: The Trillion Dollar Wake-Up Call," *Carbon Trust* Web site (September 22, 2008), www.carbontrust.com.

A survey by Bain & Company reported that 50% of *Fortune 1,000* companies in North America and about 40% in Europe use a version of the balanced scorecard.[45] Another survey reported that the balanced scorecard is used by over half of *Fortune's Global 1000* companies.[46] A study of the *Fortune 500* firms in the U.S. and the *Post 300* firms in Canada revealed the most popular non-financial measures to be customer satisfaction, customer service, product quality, market share, productivity, service quality, and core competencies. New product development, corporate culture, and market growth were not far behind.[47] DuPont's Engineering Polymers Division uses the balanced scorecard to align employees, business units, and shared services

around a common strategy involving productivity improvements and revenue growth.[48] Corporate experience with the balanced scorecard reveals that a firm should tailor the system to suit its situation, not just adopt it as a cookbook approach. When the balanced scorecard complements corporate strategy, it improves performance. Using the method in a mechanistic fashion without any link to strategy hinders performance and may even decrease it.[49]

Evaluating Top Management and the Board of Directors

Through its strategy, audit, and compensation committees, a board of directors closely evaluates the job performance of the CEO and the top management team. The vast majority of American (91%), European (75%), and Asian (75%) boards review the CEO's performance using a formalized process.[50] Objective evaluations of the CEO by the board are very important given that CEOs tend to evaluate senior management's performance significantly more positively than do other executives.[51] The board is concerned primarily with overall corporate profitability as measured quantitatively by ROI, ROE, EPS, and shareholder value. The absence of short-run profitability certainly contributes to the firing of any CEO. The board, however, is also concerned with other factors.

Members of the compensation committees of today's boards of directors generally agree that a CEO's ability to establish strategic direction, build a management team, and provide leadership are more critical in the long run than are a few quantitative measures. The board should evaluate top management not only on the typical output-oriented quantitative measures, but also on behavioral measures—factors relating to its strategic management practices. According to a survey by Korn/Ferry International, the criteria used by American boards are financial (81%), ethical behavior (63%), thought leadership (58%), corporate reputation (32%), stock price performance (22%), and meeting participation (10%).[52] The specific items that a board uses to evaluate its top management should be derived from the objectives that both the board and top management agreed on earlier. If better relations with the local community and improved safety practices in work areas were selected as objectives for the year (or for five years), these items should be included in the evaluation. In addition, other factors that tend to lead to profitability might be included, such as market share, product quality, or investment intensity.

Performance evaluations of the overall board's performance are standard practice for 87% of directors in the Americas, 72% in Europe, and 62% in Asia.[53] Evaluations of individual directors are less common. According to a PriceWaterhouseCoopers survey of 1,100 directors, 77% of the directors agreed that individual directors should be appraised regularly on their performance, but only 37% responded that they actually do so.[54] Corporations that have successfully used board performance appraisal systems are Target, Radio Shack, Eastman Chemical Company, Bell South, Raytheon, and Gillette.[55]

Chairman-CEO Feedback Instrument. An increasing number of companies are evaluating their CEO by using a 17-item questionnaire developed by Ram Charan, an authority on corporate governance. The questionnaire focuses on four key areas: (1) company performance, (2) leadership of the organization, (3) team-building and management succession, and (4) leadership of external constituencies.[56] After taking an hour to complete the questionnaire, the board of KeraVision, Inc., used it as a basis for a lengthy discussion with the CEO, Thomas Loarie. The board criticized Loarie for "not tempering enthusiasm with reality" and urged Loarie to develop a clear management succession plan. The evaluation caused Loarie to more closely involve the board in setting the company's primary objectives and discussing "where we are, where we want to go, and the operating environment."[57]

Management Audit. **Management audits** are very useful to boards of directors in evaluating management's handling of various corporate activities. Management audits have been developed to evaluate activities such as corporate social responsibility, functional areas such

as the marketing department, and divisions such as the international division. These can be helpful if the board has selected particular functional areas or activities for improvement.

Strategic Audit. The strategic audit, presented in the **Chapter 1 Appendix 1.A**, is a type of management audit. The strategic audit provides a checklist of questions, by area or issue, that enables a systematic analysis of various corporate functions and activities to be made. It is a type of management audit and is extremely useful as a diagnostic tool to pinpoint corporate-wide problem areas and to highlight organizational strengths and weaknesses.[58] A strategic audit can help determine why a certain area is creating problems for a corporation and help generate solutions to the problem. As such, it can be very useful in evaluating the performance of top management.

PRIMARY MEASURES OF DIVISIONAL AND FUNCTIONAL PERFORMANCE

Companies use a variety of techniques to evaluate and control performance in divisions, strategic business units (SBUs), and functional areas. If a corporation is composed of SBUs or divisions, it will use many of the same performance measures (ROI or EVA, for instance) that it uses to assess overall corporate performance. To the extent that it can isolate specific functional units such as R&D, the corporation may develop responsibility centers. It will also use typical functional measures, such as market share and sales per employee (marketing), unit costs and percentage of defects (operations), percentage of sales from new products and number of patents (R&D), and turnover and job satisfaction (HRM). For example, FedEx uses Enhanced Tracker software with its COSMOS database to track the progress of its 2.5 to 3.5 million shipments daily. As a courier is completing her or his day's activities, the Enhanced Tracker asks whether the person's package count equals the Enhanced Tracker's count. If the count is off, the software helps reconcile the differences.[59]

During strategy formulation and implementation, top management approves a series of programs and supporting *operating budgets* from its business units. During evaluation and control, actual expenses are contrasted with planned expenditures, and the degree of variance is assessed. This is typically done on a monthly basis. In addition, top management will probably require *periodic statistical reports* summarizing data on such key factors as the number of new customer contracts, the volume of received orders, and productivity figures.

Responsibility Centers

Control systems can be established to monitor specific functions, projects, or divisions. Budgets are one type of control system that is typically used to control the financial indicators of performance. **Responsibility centers** are used to isolate a unit so that it can be evaluated separately from the rest of the corporation. Each responsibility center, therefore, has its own budget and is evaluated on its use of budgeted resources. It is headed by the manager responsible for the center's performance. The center uses resources (measured in terms of costs or expenses) to produce a service or a product (measured in terms of volume or revenues). There are five major types of responsibility centers. The type is determined by the way the corporation's control system measures these resources and services or products.

1. **Standard cost centers: Standard cost centers** are primarily used in manufacturing facilities. Standard (or expected) costs are computed for each operation on the basis of historical data. In evaluating the center's performance, its total standard costs are multiplied by the units produced. The result is the *expected* cost of production, which is then compared to the *actual* cost of production.

2. **Revenue centers:** With **revenue centers**, production, usually in terms of unit or dollar sales, is measured without consideration of resource costs (for example, salaries). The center is thus judged in terms of effectiveness rather than efficiency. The effectiveness of a sales region, for example, is determined by comparing its actual sales to its projected or previous year's sales. Profits are not considered because sales departments have very limited influence over the cost of the products they sell.
3. **Expense centers:** Resources are measured in dollars, without consideration for service or product costs. Thus budgets will have been prepared for engineered expenses (costs that can be calculated) and for discretionary expenses (costs that can be only estimated). Typical **expense centers** are administrative, service, and research departments. They cost a company money, but they only indirectly contribute to revenues.
4. **Profit centers:** Performance is measured in terms of the difference between revenues (which measure production) and expenditures (which measure resources). A **profit center** is typically established whenever an organizational unit has control over both its resources and its products or services. By having such centers, a company can be organized into divisions of separate product lines. The manager of each division is given autonomy to the extent that he or she is able to keep profits at a satisfactory (or better) level.

   Some organizational units that are not usually considered potentially autonomous can, for the purpose of profit center evaluations, be made so. A manufacturing department, for example, can be converted from a standard cost center (or expense center) into a profit center; it is allowed to charge a transfer price for each product it "sells" to the sales department. The difference between the manufacturing cost per unit and the agreed-upon transfer price is the unit's "profit."

   Transfer pricing is commonly used in vertically integrated corporations and can work well when a price can be easily determined for a designated amount of product. Even though most experts agree that market-based transfer prices are the best choice, only 30%–40% of companies use market price to set the transfer price. (Of the rest, 50% use cost; 10%–20% use negotiation.)[60] When a price cannot be set easily, however, the relative bargaining power of the centers, rather than strategic considerations, tends to influence the agreed-upon price. Top management has an obligation to make sure that these political considerations do not overwhelm the strategic ones. Otherwise, profit figures for each center will be biased and provide poor information for strategic decisions at both the corporate and divisional levels.
5. **Investment centers:** Because many divisions in large manufacturing corporations use significant assets to make their products, their asset base should be factored into their performance evaluation. Thus it is insufficient to focus only on profits, as in the case of profit centers. An **investment center's** performance is measured in terms of the difference between its resources and its services or products. For example, two divisions in a corporation made identical profits, but one division owns a $3 million plant, whereas the other owns a $1 million plant. Both make the same profits, but one is obviously more efficient; the smaller plant provides the shareholders with a better return on their investment. The most widely used measure of investment center performance is ROI.

Most single-business corporations, such as Apple, tend to use a combination of cost, expense, and revenue centers. In these corporations, most managers are functional specialists and manage against a budget. Total profitability is integrated at the corporate level. Multidivisional corporations with one dominating product line (such as Anheuser-Busch), that have diversified into a few businesses but that still depend on a single product line (such as beer) for most of their revenue and income, generally use a combination of cost, expense, revenue, and profit centers. Multidivisional corporations, such as General Electric, tend to emphasize investment centers—although in various units throughout the corporation other types of responsibility

centers are also used. One problem with using responsibility centers, however, is that the separation needed to measure and evaluate a division's performance can diminish the level of cooperation among divisions that is needed to attain synergy for the corporation as a whole. (This problem is discussed later in this chapter, under "Suboptimization.")

Using Benchmarking to Evaluate Performance

According to Xerox Corporation, the company that pioneered this concept in the United States, **benchmarking** is "the continual process of measuring products, services, and practices against the toughest competitors or those companies recognized as industry leaders."[61] Benchmarking, an increasingly popular program, is based on the concept that it makes no sense to reinvent something that someone else is already using. It involves openly learning how others do something better than one's own company so that the company not only can imitate, but perhaps even improve on its techniques. The benchmarking process usually involves the following steps:

1. Identify the area or process to be examined. It should be an activity that has the potential to determine a business unit's competitive advantage.
2. Find behavioral and output measures of the area or process and obtain measurements.
3. Select an accessible set of competitors and best-in-class companies against which to benchmark. These may very often be companies that are in completely different industries, but perform similar activities. For example, when Xerox wanted to improve its order fulfillment, it went to L. L. Bean, the successful mail order firm, to learn how it achieved excellence in this area.
4. Calculate the differences among the company's performance measurements and those of the best-in-class and determine why the differences exist.
5. Develop tactical programs for closing performance gaps.
6. Implement the programs and then compare the resulting new measurements with those of the best-in-class companies.

Benchmarking has been found to produce best results in companies that are already well managed. Apparently poorer performing firms tend to be overwhelmed by the discrepancy between their performance and the benchmark—and tend to view the benchmark as too difficult to reach.[62] Nevertheless, a survey by Bain & Company of 460 companies of various sizes across all U.S. industries indicated that more than 70% were using benchmarking in either a major or limited manner.[63] Cost reductions range from 15% to 45%.[64] Benchmarking can also increase sales, improve goal setting, and boost employee motivation.[65] The average cost of a benchmarking study is around $100,000 and involves 30 weeks of effort.[66] Manco, Inc., a small Cleveland-area producer of duct tape regularly benchmarks itself against Wal-Mart, Rubbermaid, and Pepsico to enable it to better compete with giant 3M. APQC (American Productivity & Quality Center), a Houston research group, established the Open Standards Benchmarking Collaborative database, composed of more than 1,200 commonly used measures and individual benchmarks, to track the performance of core operational functions. Firms can submit their performance data to this online database to learn how they compare to top performers and industry peers (see www.apqc.org).

INTERNATIONAL MEASUREMENT ISSUES

The three most widely used techniques for international performance evaluation are ROI, budget analysis, and historical comparisons. In one study, 95% of the corporate officers interviewed stated that they use the same evaluation techniques for foreign and domestic operations.

Rate of return was mentioned as the single most important measure.[67] However, ROI can cause problems when it is applied to international operations: Because of foreign currencies, different accounting systems, different rates of inflation, different tax laws, and the use of transfer pricing, both the net income figure and the investment base may be seriously distorted.[68] To deal with different accounting systems throughout the world, the London-based International Accounting Standards Board developed International Financial Reporting Standards (IFRS) to harmonize accounting practices. Over 100 countries have thus far adopted the rules. Foreign-based companies operating in the U.S. have a choice starting 2009 of using IFRS accounting standards or continuing the costly process translating their accounts using America's Generally Accepted Accounting Principles (GAAP). Nevertheless, enforcement and cultural interpretations of the international rules can still vary by country and may undercut what is hoped to be a uniform accounting system.[69]

A study of 79 MNCs revealed that *international transfer pricing* from one country unit to another is primarily used not to evaluate performance but to minimize taxes.[70] Taxes are an important issue for MNCs, given that corporate tax rates vary from 55% in Kuwait, 41% in Japan, 40% in the United States, and 34% in Canada and India, to 28% in the UK, South Korea, and Mexico, 25% in China, 18% in Singapore, 10% in Albania, and 0% in Bahrain and the Cayman Islands.[71] For example, the U.S. Internal Revenue Service contended in the early 1990s that many Japanese firms doing business in the United States artificially inflated the value of U.S. deliveries in order to reduce the profits and thus the taxes of their American subsidiaries.[72] Parts made in a subsidiary of a Japanese MNC in a low-tax country such as Singapore could be shipped to its subsidiary in a high-tax country such as the United States at such a high price that the U.S. subsidiary reports very little profit (and thus pays few taxes), while the Singapore subsidiary reports a very high profit (but also pays few taxes because of the lower tax rate). A Japanese MNC could, therefore, earn more profit worldwide by reporting less profit in high-tax countries and more profit in low-tax countries. Transfer pricing can thus be one way the parent company can reduce taxes and "capture profits" from a subsidiary. Other common ways of transferring profits to the parent company (often referred to as the *repatriation of profits*) are through dividends, royalties, and management fees.[73]

Among the most important barriers to international trade are the different standards for products and services. There are at least three categories of standards: safety/environmental, energy efficiency, and testing procedures. Existing standards have been drafted by such bodies as the British Standards Institute (BSI-UK) in the United Kingdom, Japanese Industrial Standards Committee (JISC), AFNOR in France, DIN in Germany, CSA in Canada, and American Standards Institute in the United States. These standards traditionally created entry barriers that served to fragment various industries, such as major home appliances, by country. The International Electrotechnical Commission (IEC) standards were created to harmonize standards in the European Union and eventually to serve as worldwide standards, with some national deviations to satisfy specific needs. Because the European Union (EU) was the first to harmonize the many different standards of its member countries, the EU is shaping standards for the rest of the world. In addition, the International Organization for Standardization (ISO) is preparing and publishing international standards. These standards provide a foundation for regional associations to build upon. CANENA, the Council for Harmonization of Electrotechnical Standards of the Nations of the Americas, was created in 1992 to further coordinate the harmonization of standards in North and South America. Efforts are also under way in Asia to harmonize standards.[74]

An important issue in international trade is counterfeiting/piracy. Firms in developing nations around the world make money by making counterfeit/pirated copies of well-known name-brand products and selling them globally as well as locally. See the **Global Issue** feature to learn how this is being done.

Authorities in international business recommend that the control and reward systems used by a global MNC be different from those used by a multidomestic MNC.[75] A *multidomestic*

GLOBAL issue

COUNTERFEIT GOODS & PIRATED SOFTWARE: A GLOBAL PROBLEM

"We know that 15 to 20 percent of all goods in China are counterfeit," states Dan Chow, a law professor at Ohio State University. This includes products from Tide detergent and Budweiser beer to Marlboro cigarettes. There is a saying in Shanghai, China: "We can copy everything except your mother." Yamaha estimates that five out of every six bikes bearing its brand name are fake. Fake Cisco network routers (known as "Chiscos") and counterfeit Nokia mobile phones can be easily found throughout China. Procter & Gamble estimates that 15% of the soaps and detergents under its Head & Shoulders, Vidal Sassoon, Safeguard, and Tide brands in China are counterfeit, costing the company $150 million in lost sales.

In Yiwu, a few hours from Shanghai, one person admitted to a *60 Minutes* reporter that she could make 1,000 pairs of counterfeit Nike shoes in 10 days for $4.00 a pair. According to the market research firm Automotive Resources, the profit margins on counterfeit shock absorbers can reach 80% versus only 15% for the real ones. The World Custom Organization estimates that 7% of the world's merchandise is bogus.

Tens of thousands of counterfeiters are active in China. They range from factories mixing shampoo and soap in back rooms to large state-owned enterprises making copies of soft drinks and beer. Other factories make everything from car batteries to automobiles. Mobile CD factories with optical disc-mastering machines counterfeit music and software. *60 Minutes* found a small factory in Donguan making fake Callaway golf clubs and bags at a rate of 500 bags per week. Factories in southern Guangdong or Fujian provinces truck their products to a central distribution center, such as the one in Yiwu. They may also be shipped across the border into Russia, Pakistan, Vietnam, or Burma. Chinese counterfeiters have developed a global reach through their connections with organized crime.

As much as 35% of software on personal computers worldwide is pirated, according to the Business Software Alliance and ISDC, a market research firm. The worldwide cost of software piracy was around $34 billion in 2005. For example, 21% of the software sold in the United States is pirated. That figure increases to 26%–30% in the European Union, 83% in Russia, Algeria, and Bolivia, to 86% in China, 87% in Indonesia, and 90% in Vietnam.

SOURCES: "The Sincerest Form of Flattery," *The Economist* (April 7, 2007), pp. 64–65; F. Balfour, "Fakes!" Business Week (February 7, 2005), pp. 54–64; "PC Software Piracy," *The Economist* (June 10, 2006), p. 102; "The World's Greatest Fakes," *60 Minutes*, CBS News (August 8, 2004); "Business Software Piracy," *Pocket World in Figures 2004* (London: Economist & Profile Book, 2003), p. 60; D. Roberts, F. Balfour, P. Magnusson, P. Engardio, and J. Lee, "China's Piracy Plague," *Business Week* (June 5, 2000), pp. 44–48.

MNC should use loose controls on its foreign units. The management of each geographic unit should be given considerable operational latitude, but it should be expected to meet some performance targets. Because profit and ROI measures are often unreliable in international operations, it is recommended that the MNC's top management, in this instance, emphasize budgets and non-financial measures of performance such as market share, productivity, public image, employee morale, and relations with the host country government.[76] Multiple measures should be used to differentiate between the worth of the subsidiary and the performance of its management.

A *global MNC*, however, needs tight controls over its many units. To reduce costs and gain competitive advantage, it is trying to spread the manufacturing and marketing operations of a few fairly uniform products around the world. Therefore, its key operational decisions must be centralized. Its environmental scanning must include research not only into each of the national markets in which the MNC competes but also into the "global arena" of the interaction between markets. Foreign units are thus evaluated more as cost centers, revenue centers, or expense centers than as investment or profit centers because MNCs operating in a global industry do not often make the entire product in the country in which it is sold.

11.3 Strategic Information Systems

Before performance measures can have any impact on strategic management, they must first be communicated to the people responsible for formulating and implementing strategic plans. Strategic information systems can perform this function. They can be computer based or manual, formal or informal. One of the key reasons given for the bankruptcy of International Harvester was the inability of the corporation's top management to precisely determine income by major class of similar products. Because of this inability, management kept trying to fix ailing businesses and was unable to respond flexibly to major changes and unexpected events. In contrast, one of the key reasons for the success of Wal-Mart has been management's use of the company's sophisticated information system to control purchasing decisions. Cash registers in Wal-Mart retail stores transmit information hourly to computers at company headquarters. Consequently, managers know every morning exactly how many of each item were sold the day before, how many have been sold so far in the year, and how this year's sales compare to last year's. The information system allows all reordering to be done automatically by computers, without any managerial input. It also allows the company to experiment with new products without committing to big orders in advance. In effect, the system allows the customers to decide through their purchases what gets reordered.

ENTERPRISE RESOURCE PLANNING (ERP)

Many corporations around the world have adopted **enterprise resource planning (ERP)** software. ERP unites all of a company's major business activities, from order processing to production, within a single family of software modules. The system provides instant access to critical information to everyone in the organization, from the CEO to the factory floor worker. Because of the ability of ERP software to use a common information system throughout a company's many operations around the world, it is becoming the business information systems' global standard. The major providers of this software are SAP AG, Oracle (including PeopleSoft), J. D. Edwards, Baan, and SSA.

The German company SAP AG originated the concept with its R/3 software system. Microsoft, for example, used R/3 to replace a tangle of 33 financial tracking systems in 26 subsidiaries. Even though it cost the company $25 million and took 10 months to install, R/3 annually saves Microsoft $18 million. Coca-Cola uses the R/3 system to enable a manager in Atlanta to use her personal computer to check the latest sales of 20-ounce bottles of Coke Classic in India. Owens-Corning envisioned that its R/3 system allowed salespeople to learn what was available at any plant or warehouse and to quickly assemble orders for customers.

ERP may not fit every company, however. The system is extremely complicated and demands a high level of standardization throughout a corporation. Its demanding nature often forces companies to change the way they do business. There are three reasons ERP could fail: (1) insufficient tailoring of the software to fit the company, (2) inadequate training, and (3) insufficient implementation support.[77] Over the two-year period of installing R/3, Owens-Corning had to completely overhaul its operations. Because R/3 was incompatible with Apple's very organic corporate culture, the company was able to apply it only to its order management and financial operations, but not to manufacturing. Other companies that had difficulty installing and using ERP are Whirlpool, Hershey Foods, Volkswagen, and Stanley Works. At Whirlpool, SAP's software led to missed and delayed shipments, causing Home Depot to cancel its agreement for selling Whirlpool products.[78] One survey found that 65% of executives believed that ERP had a moderate chance of hurting their business because of

implementation problems. Nevertheless, the payoff from ERP software is likely to be worth the effort. ERP is a key ingredient for gaining competitive advantage, streamlining operations, and managing a lean manufacturing system.[79]

RADIO FREQUENCY IDENTIFICATION (RFID)

Radio frequency identification (RFID) is an electronic tagging technology used in a number of companies to improve supply-chain efficiency. By tagging containers and items with tiny chips, companies use the tags as wireless bar-codes to track inventory more efficiently. Both Wal-Mart and the U.S. Department of Defense began requiring their largest suppliers to incorporate RFID tags in their goods in 2003. Although Tesco has experimented with RFID in Europe, full-scale use of the technology proved unfeasible because of incompatible standards. Nevertheless, some suppliers and retailers of expensive consumer products view the cost of the tag as worthwhile because it reduces losses from counterfeiting and theft. RFID technology is currently in wide use as wireless commuter passes for toll roads, tunnels, and bridges. Even though RFID standards may vary among companies, individual firms like Audi, Sony, and Dole Food use the tags to track goods within their own factories and warehouses.[80] According to Dan Mullen of AIM Global, "RFID will go through a process similar to what happened in bar code technology 20 years ago. . . . As companies implement the technology deeper within their operations, the return on investment will grow and applications will expand."[81]

DIVISIONAL AND FUNCTIONAL IS SUPPORT

At the divisional or SBU level of a corporation, the information system should be used to support, reinforce, or enlarge its business-level strategy through its decision support system. An SBU pursuing a strategy of overall cost leadership could use its information system to reduce costs either by improving labor productivity or improving the use of other resources such as inventory or machinery. Merrill Lynch took this approach when it developed PRISM software to provide its 500 U.S. retail offices with quick access to financial information in order to boost brokers' efficiency. Another SBU, in contrast, might want to pursue a differentiation strategy. It could use its information system to add uniqueness to the product or service and contribute to quality, service, or image through the functional areas. FedEx wanted to use superior service to gain a competitive advantage. It invested significantly in several types of information systems to measure and track the performance of its delivery service. Together, these information systems gave FedEx the fastest error-response time in the overnight delivery business.

11.4 Problems in Measuring Performance

The measurement of performance is a crucial part of evaluation and control. The lack of quantifiable objectives or performance standards and the inability of the information system to provide timely and valid information are two obvious control problems. According to Meg Whitman, past-CEO of eBay, "If you can't measure it, you can't control it." That's why eBay has a multitude of measures, from total revenues and profits to *take rate*, the ratio of revenues to the value of goods traded on the site.[82] Without objective and timely measurements, it would be extremely difficult to make operational, let alone strategic, decisions. Nevertheless, the use of timely, quantifiable standards does not guarantee good performance. The very act of monitoring and measuring performance can cause side effects that interfere with overall corporate performance. Among the most frequent negative side effects are a short-term orientation and goal displacement.

SHORT-TERM ORIENTATION

Top executives report that in many situations, they analyze neither the long-term implications of present operations on the strategy they have adopted nor the operational impact of a strategy on the corporate mission. Long-run evaluations may not be conducted because executives (1) don't realize their importance, (2) believe that short-run considerations are more important than long-run considerations, (3) aren't personally evaluated on a long-term basis, or (4) don't have the time to make a long-run analysis.[83] There is no real justification for the first and last reasons. If executives realize the importance of long-run evaluations, they make the time needed to conduct them. Even though many chief executives point to immediate pressures from the investment community and to short-term incentive and promotion plans to support the second and third reasons, evidence does not always support their claims.[84]

At one international heavy-equipment manufacturer, managers were so strongly motivated to achieve their quarterly revenue target that they shipped unfinished products from their plant in England to a warehouse in the Netherlands for final assembly. By shipping the incomplete products, they were able to realize the sales before the end of the quarter—thus fulfilling their budgeted objective and making their bonuses. Unfortunately, the high cost of assembling the goods at a distant location (requiring not only the renting the warehouse but also paying additional labor) ended up reducing the company's overall profit.[85]

Many accounting-based measures, such as EPS and ROI, encourage a **short-term orientation** in which managers consider only current tactical or operational issues and ignore long-term strategic ones. Because growth in EPS (earnings per share) is an important driver of near-term stock price, top managers are biased against investments that might reduce short-term EPS.[86] This is compounded by pressure from financial analysts and investors for quarterly *earnings guidance*, that is, estimates of future corporate earnings.[87] For example, in a $303 million law suit settled in 2008, General Motors admitted that its top managers and auditor had misstated its revenue, earnings, and cash flow in order to artificially inflate the company's stock price and debt securities.[88]

Table 11.1 indicates that one of the limitations of ROI as a performance measure is its short-term nature. In theory, ROI is not limited to the short run, but in practice it is often difficult to use this measure to realize long-term benefits for a company. Because managers can often manipulate both the numerator (earnings) and the denominator (investment), the resulting ROI figure can be meaningless. Advertising, maintenance, and research efforts can be reduced. Estimates of pension-fund profits, unpaid receivables, and old inventory, are easy to adjust. Optimistic estimates of returned products, bad debts, and obsolete inventory inflate the present year's sales and earnings.[89] Expensive retooling and plant modernization can be delayed as long as a manager can manipulate figures on production defects and absenteeism. In a recent survey of financial executives, 80% of the managers stated that they would decrease spending on research and development, advertising, maintenance, and hiring in order to meet earnings targets. More than half said that they would delay a new project even if it meant sacrificing value.[90]

Mergers can be undertaken that will do more for the present year's earnings (and the next year's paycheck) than for the division's or corporation's future profits. For example, research on 55 firms that engaged in major acquisitions revealed that even though the firms performed poorly after the acquisition, the acquiring firms' top management still received significant increases in compensation.[91] Determining CEO compensation on the basis of firm size rather than performance is typical and is particularly likely for firms that are not monitored closely by independent analysts.[92]

Research supports the conclusion that many CEOs and their friends on the board of directors' compensation committee manipulate information to provide themselves a pay raise.[93] For example, CEOs tend to announce bad news—thus reducing the company's stock price—just before the issuance of stock options. Once the options are issued, the CEOs tend to announce good news—thus raising the stock price and making their options more valuable.[94] Board

compensation committees tend to expand the peer group comparison outside their industry to include lower-performing firms to justify a high raise to the CEO. They tend to do this when the company performs poorly, the industry performs well, the CEO is already highly paid, and shareholders are powerful and active.[95]

GOAL DISPLACEMENT

If not carefully done, monitoring and measuring of performance can actually result in a decline in overall corporate performance. **Goal displacement** is the confusion of means with ends and occurs when activities originally intended to help managers attain corporate objectives become ends in themselves—or are adapted to meet ends other than those for which they were intended. Two types of goal displacement are behavior substitution and suboptimization.

Behavior Substitution

Behavior substitution refers to a phenomenon when people substitute activities that do not lead to goal accomplishment for activities that do lead to goal accomplishment because the wrong activities are being rewarded. Managers, like most other people, tend to focus more of their attention on behaviors that are clearly measurable than on those that are not. Employees often receive little or no reward for engaging in hard-to-measure activities such as cooperation and initiative. However, easy-to-measure activities might have little or no relationship to the desired good performance. Rational people, nevertheless, tend to work for the rewards that the system has to offer. Therefore, people tend to substitute behaviors that are recognized and rewarded for behaviors that are ignored, without regard to their contribution to goal accomplishment. A research study of 157 corporations revealed that most of the companies made little attempt to identify areas of non-financial performance that might advance their chosen strategy. Only 23% consistently built and verified cause-and-effect relationships between intermediate controls (such as number of patents filed or product flaws) and company performance.[96]

A U.S. Navy quip sums up this situation: "What you inspect (or reward) is what you get." If the reward system emphasizes quantity while merely asking for quality and cooperation, the system is likely to produce a large number of low-quality products and unsatisfied customers.[97] A proposed law governing the effect of measurement on behavior is that *quantifiable measures drive out non-quantifiable measures*.

A classic example of behavior substitution happened a few years ago at Sears. Sears' management thought that it could improve employee productivity by tying performance to rewards. It, therefore, paid commissions to its auto shop employees as a percentage of each repair bill. Behavior substitution resulted as employees altered their behavior to fit the reward system. The results were over-billed customers, charges for work never done, and a scandal that tarnished Sears' reputation for many years.[98]

Suboptimization

Suboptimization refers to the phenomenon of a unit optimizing its goal accomplishment to the detriment of the organization as a whole. The emphasis in large corporations on developing separate responsibility centers can create some problems for the corporation as a whole. To the extent that a division or functional unit views itself as a separate entity, it might refuse to cooperate with other units or divisions in the same corporation if cooperation could in some way negatively affect its performance evaluation. The competition between divisions to achieve a high ROI can result in one division's refusal to share its new technology or work process improvements. One division's attempt to optimize the accomplishment of its goals can cause other divisions to fall behind and thus negatively affect overall corporate performance. One common example of suboptimization occurs when a marketing department approves an early shipment date to a customer as a means of getting an order and forces the manufacturing department into

overtime production for that one order. Production costs are raised, which reduces the manufacturing department's overall efficiency. The end result might be that, although marketing achieves its sales goal, the corporation as a whole fails to achieve its expected profitability.[99]

11.5 Guidelines for Proper Control

In designing a control system, top management should remember that controls should follow strategy. Unless controls ensure the use of the proper strategy to achieve objectives, there is a strong likelihood that dysfunctional side effects will completely undermine the implementation of the objectives. The following guidelines are recommended:

1. **Control should involve only the minimum amount of information needed to give a reliable picture of events:** Too many controls create confusion. Focus on the strategic factors by following the **80/20 rule**: *Monitor those 20% of the factors that determine 80% of the results.* See **Strategy Highlight 11.1** for some additional rules of thumb used by strategists.
2. **Controls should monitor only meaningful activities and results, regardless of measurement difficulty:** If cooperation between divisions is important to corporate performance, some form of qualitative or quantitative measure should be established to monitor cooperation.
3. **Controls should be timely so that corrective action can be taken before it is too late:** Steering controls, controls that monitor or measure the factors influencing performance, should be stressed so that advance notice of problems is given.

STRATEGY highlight 11.1

SOME RULES OF THUMB IN STRATEGY

Managers use many *rules of thumb,* such as the 80/20 rule, in making strategic decisions. These "rules" are primarily approximations based on years of practical experience by many managers. Although most of these rules have no objective data to support them, they are often accepted by practicing managers as a way of estimating the cost or time necessary to conduct certain activities. They may be useful because they can help narrow the number of alternatives into a shorter list for more detailed analysis. Some of the rules of thumb used by experienced strategists are described here.

INDIRECT COSTS OF STRATEGIC INITIATIVES

- The R&D *Rule of Sevens* is that for every $1 spent in developing a new prototype, $7 will be needed to get a product ready for market, and $7 additional dollars will be required to get to the first sale. These estimates don't cover working capital requirements for stocking distributor inventories.
- First-year costs for promoting a new consumer goods product are 33% of anticipated first-year sales. Second-year costs should be 20%, and third-year costs 15%.
- A reasonably successful patent-based innovation will require $2 million in legal defense costs.

SAFETY MARGINS FOR NEW BUSINESS INITIATIVES

- A new manufacturing business should have sufficient startup capital to cover one year of costs.
- A new consumer goods business should have sufficient capital to cover two years of business.
- A new professional services business should have sufficient capital to cover three years of costs.

SOURCE: R. West and F. Wolek, "Rules of Thumb in Strategic Thinking," *Strategy & Leadership* (March/April 1999), p. 34. Copyright © 1999 by Emerald Group Publishing Ltd. Reprinted by permission.

4. **Long-term *and* short-term controls should be used:** If only short-term measures are emphasized, a short-term managerial orientation is likely.
5. **Controls should aim at pinpointing exceptions:** Only activities or results that fall outside a predetermined tolerance range should call for action.
6. **Emphasize the reward of meeting or exceeding standards rather than punishment for failing to meet standards:** Heavy punishment of failure typically results in goal displacement. Managers will "fudge" reports and lobby for lower standards.

If corporate culture complements and reinforces the strategic orientation of a firm, there is less need for an extensive formal control system. In their book *In Search of Excellence*, Peters and Waterman state that "the stronger the culture and the more it was directed toward the marketplace, the less need was there for policy manuals, organization charts, or detailed procedures and rules. In these companies, people way down the line know what they are supposed to do in most situations because the handful of guiding values is crystal clear."[100] For example, at Eaton Corporation, the employees are expected to enforce the rules themselves. If someone misses too much work or picks fights with co-workers, other members of the production team point out the problem. According to Randy Savage, a long-time Eaton employee, "They say there are no bosses here, but if you screw up, you find one pretty fast."[101]

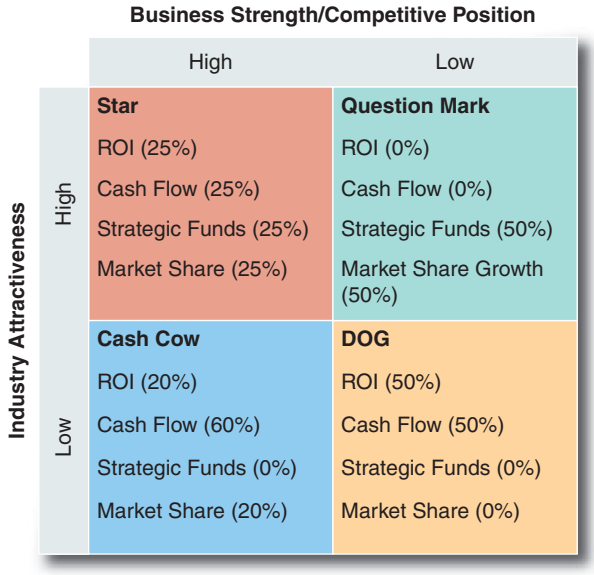
11.6 Strategic Incentive Management

To ensure congruence between the needs of a corporation as a whole and the needs of the employees as individuals, management and the board of directors should develop an incentive program that rewards desired performance. This reduces the likelihood of the agency problems (when employees act to feather their own nests instead of building shareholder value) mentioned earlier in **Chapter 2**. Incentive plans should be linked in some way to corporate and divisional strategy. Research reveals that firm performance is affected by its compensation policies.[102] Companies using different strategies tend to adopt different pay policies. For example, a survey of 600 business units indicates that the pay mix associated with a growth strategy emphasizes bonuses and other incentives over salary and benefits, whereas the pay mix associated with a stability strategy has the reverse emphasis.[103] Research indicates that SBU managers having long-term performance elements in their compensation program favor a long-term perspective and thus greater investments in R&D, capital equipment, and employee training.[104] Although the typical CEO pay package is composed of 21% salary, 27% short-term annual incentives, 16% long-term incentives, and 36% stock options,[105] there is some evidence that stock options are being replaced by greater emphasis on performance-related pay.[106]

The following three approaches are tailored to help match measurements and rewards with explicit strategic objectives and time frames:[107]

1. **Weighted-factor method:** The weighted-factor method is particularly appropriate for measuring and rewarding the performance of top SBU managers and group-level executives when performance factors and their importance vary from one SBU to another. Using portfolio analysis, one corporation's measurements might contain the following variations: the performance of high-performing (star) SBUs is measured equally in terms of ROI, cash flow, market share, and progress on several future-oriented strategic projects; the performance of low-growth, but strong (cash cow) SBUs, in contrast, is measured in terms of ROI, market share, and cash generation; and the performance of developing (question marks) SBUs is measured in terms of development and market share growth with no weight on ROI or cash flow. (Refer to **Figure 11.3.**)
2. **Long-term evaluation method:** The **long-term evaluation method** compensates managers for achieving objectives set over a multiyear period. An executive is promised some company stock or "performance units" (convertible into money or stock) in amounts to be

FIGURE 11–3
Weighted-Factor Approach to Strategic Incentive Management



SOURCE: Based on Paul J. Stonich, "The Performance Measurement and Reward System: Critical to Strategic Management," *Organizational Dynamics*, (Winter 1984), pp. 45–57.

based on long-term performance. A board of directors, for example, might set a particular objective in terms of growth in earnings per share during a five-year period. The giving of awards would be contingent on the corporation's meeting that objective within the designated time. Any executive who leaves the corporation before the objective is met receives nothing. The typical emphasis on stock prices makes this approach more applicable to top management than to business unit managers. Because rising stock markets tend to raise the stock price of mediocre companies, there is a developing trend to index stock options to competitors or to the *Standard & Poor's 500*.[108] General Electric, for example, offered its CEO 250,000 performance share units (PSUs) tied to performance targets achieved over five years. Half of the PSUs convert into GE stock only if GE achieves 10% average annual growth in operations. The other half converts to stock only if total shareholder return meets or beats the *S&P 500*.[109]

3. **Strategic-funds method:** The **strategic-funds method** encourages executives to look at developmental expenses as being different from expenses required for current operations. The accounting statement for a corporate unit enters strategic funds as a separate entry below the current ROI. It is, therefore, possible to distinguish between expense dollars consumed in the generation of current revenues and those invested in the future of a business. Therefore, a manager can be evaluated on both a short- and a long-term basis and has an incentive to invest strategic funds in the future. For example, begin with the total sales of a unit ($12,300,000). Subtract cost of goods sold ($6,900,000) leaving a gross margin of $5,400,000. Subtract general and administrative expenses ($3,700,000) leaving an operating profit/ROI of $1,700,000. So far, this is standard accounting procedure. The strategic-funds approach goes one step further by subtracting an additional $1,000,000 for "strategic funds/development expenses." This results in a pretax profit of $700,000. This strategic-funds approach is a good way to ensure that the manager of a high-performing unit (e.g., star) not only generates $700,000 in ROI, but also invests $1 million in the unit for its continued growth. It also ensures that a manager of a

developing unit is appropriately evaluated on the basis of market share growth and product development and not on ROI or cash flow.

An effective way to achieve the desired strategic results through a reward system is to combine the three approaches:

1. Segregate strategic funds from short-term funds, as is done in the strategic-funds method.
2. Develop a weighted-factor chart for each SBU.
3. Measure performance on three bases: The pretax profit indicated by the strategic-funds approach, the weighted factors, and the long-term evaluation of the SBUs' and the corporation's performance.

Genentech, General Electric, Adobe, IBM, and Textron are some firms in which top management compensation is contingent upon the company's achieving strategic objectives.[110]

The board of directors and top management must be careful to develop a compensation plan that achieves the appropriate objectives. One reason why top executives are often criticized for being overpaid (the ratio of CEO to average worker pay is currently 400 to 1)[111] is that in a large number of corporations the incentives for sales growth exceed those for shareholder wealth, resulting in too many executives pursuing growth to the detriment of shareholder value.[112]

End of Chapter SUMMARY

Having strategic management without evaluation and control is like playing football without any goalposts. Unless strategic management improves performance, it is only an exercise. In business, the bottom-line measure of performance is making a profit. If people aren't willing to pay more than what it costs to make a product or provide a service, that business will not continue to exist. **Chapter 1** explains that organizations engaging in strategic management outperform those that do not. The sticky issue is: How should we measure performance? Is measuring profits sufficient? Does an income statement tell us what we need to know? The accrual method of accounting enables us to count a sale even when the cash has not yet been received. Therefore, a firm might be profitable, but still go bankrupt because it can't pay its bills. Is profit the amount of cash on hand at the end of the year after paying costs and expenses? But what if you made a big sale in December and must wait until January to get paid? Like retail stores, perhaps we need to use a fiscal year ending January 31 (to include returned Christmas items that were bought in December) instead of a calendar year ending December 31. Should two managers receive the same bonus when their divisions earn the same profit, even though one division is much smaller than the other? What of the manager who is managing a new product introduction that won't make a profit for another two years?

Evaluation and control is one of the most difficult parts of strategic management. No one measure can tell us what we need to know. That's why we need to use not only the traditional measures of financial performance, such as net earnings, ROI, and EPS, but we need to consider using EVA or MVA and a balanced scorecard, among other possibilities. On top of that, science informs us that just attempting to measure something changes what is being measured. The measurement of performance can and does result in short-term oriented actions and goal displacement. That's why experts suggest that we use multiple measures of only those things that provide a meaningful and reliable picture of events: Measure those 20% of the factors that

determine 80% of the results. Once the appropriate performance measurements are taken, it is possible to learn whether the strategy was successful. As shown in the model of strategic management depicted at the beginning this chapter, the measured results of corporate performance allow us to decide whether we need to reformulate the strategy, improve its implementation, or gather more information about our competition.

ECO-BITS

- In 2007, 64% of the Fortune Global 100 published a Corporate Social Responsibility report explaining their economic, environmental, and social performance.
- More than 4,000 organizations from over 100 countries are members of the United Nations Global Compact. Three of the 10 principles are:
  - Support a precautionary approach to environmental challenges.
  - Undertake initiatives to promote greater environmental responsibility.
  - Encourage the development and diffusion of environmentally friendly technologies.[113]

DISCUSSION QUESTIONS

1. Is Figure 11–1 a realistic model of the evaluation and control process?
2. What are some examples of behavior controls? Output controls? Input controls?
3. Is EVA an improvement over ROI, ROE, or EPS?
4. How much faith can a manager place in a transfer price as a substitute for a market price in measuring a profit center's performance?
5. Is the evaluation and control process appropriate for a corporation that emphasizes creativity? Are control and creativity compatible?

STRATEGIC PRACTICE EXERCISE

Each year, *Fortune* magazine publishes an article entitled, "America's Most Admired Companies." It lists the 10 most admired companies in the United States and in the world. *Fortune*'s rankings are based on scoring publicly held companies on what it calls "eight key attributes of reputation": innovation, people management, use of corporate assets, social responsibility, quality of management, financial soundness, long-term investment value, and quality of products/services. In 2008, *Fortune* asked Hay Group to survey more than 3,700 people from multiple industries. Respondents were asked to choose the companies they admired most, regardless of industry. *Fortune* has been publishing this list since 1982. The *2008 Fortune* list of the top 10 most admired U.S. companies were (starting with #1): Apple, Berkshire Hathaway, General Electric, Google, Toyota Motor, Starbucks, FedEx, Procter & Gamble, Johnson & Johnson, and Goldman Sachs Group. The next 10 most admired were (from 11 to 20): Target, Southwest Airlines, American Express, BMW, Costco Wholesale, Microsoft, United Parcel Service, Cisco Systems, 3M, and Nordstrom.[114]

Four years earlier in 2004, the list of 10 most admired U.S. companies was: Wal-Mart, Berkshire Hathaway, Southwest Airlines, General Electric, Dell Computer, Microsoft, Johnson & Johnson, Starbucks, FedEx, and IBM.[115]

- Why did the most admired U.S. firm in 2004 (Wal-Mart) drop off the 10 listing in 2008?
- Why did Apple go from not even being on the 10 U.S. listing in 2004 to No. 1 in 2008?
- Which firms appeared on both top 10 lists? Why?
- Why did some firms drop off the list from 2004 to 2008 and why did others get included?
- What companies should be on the most admired list this year? Why?

Try One of These Exercises

1. Go to the library and find a "Most Admired Companies" *Fortune* article from the 1980s or early 1990s and compare that list to the latest one. (See www.fortune.com for the latest list.) Which companies have fallen out of the top 10? Pick one of the companies and investigate why it is no longer on the list.

2. Given the likely impact of global warming on various industrial sectors, which companies are likely to be on *Fortune's* "Most Admired Companies" in 10 years?
3. Compare *Fortune's* list to that compiled by the Reputation Institute (www.reputationinstitute.com). Why is there a difference between the ratings?

KEY TERMS

80/20 rule (p. 351)
activity-based costing (ABC) (p. 334)
balanced scorecard (p. 339)
behavior control (p. 332)
behavior substitution (p. 350)
benchmarking (p. 344)
earnings per share (EPS) (p. 335)
economic value added (EVA) (p. 338)
enterprise resource planning (ERP) (p. 347)
enterprise risk management (ERM) (p. 335)
evaluation and control process (p. 328)
expense center (p. 343)
free cash flow (p. 336)
goal displacement (p. 350)
input control (p. 333)
investment center (p. 343)
ISO 9000 Standards Service (p. 333)
ISO 14000 Standards Service (p. 333)
key performance measures (p. 339)
long-term evaluation method (p. 352)
management audit (p. 341)
market value added (MVA) (p. 338)
operating cash flow (p. 336)
output control (p. 332)
performance (p. 332)
profit center (p. 343)
responsibility center (p. 342)
return on equity (ROE) (p. 336)
return on investment (ROI) (p. 335)
revenue center (p. 343)
shareholder value (p. 337)
short-term orientation (p. 349)
standard cost center (p. 342)
steering control (p. 332)
strategic-funds method (p. 353)
suboptimization (p. 350)
transfer pricing (p. 343)
weighted-factor method (p. 352)

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Ending Case for Part Four

HEWLETT-PACKARD BUYS EDS

On May 13, 2008, Hewlett-Packard (HP) announced its $13.9 billion acquisition of Electronic Data Systems (EDS), a technology services company. Together, HP and EDS formed a formidable tech services provider with $38 billion in revenues. It enabled HP to better compete with IBM, which controlled more than 7% market share of the $748 billion market for services. Tech services included managing the data centers of large companies and governments, or handling entire functions such as personnel or claims processing. At the time of the acquisition, IBM was the leading firm in the area, with EDS in second place with much lower profit margins, and HP following in fifth place.

Founded by Ross Perot in 1962, EDS pioneered the business of outsourced data management. Perot sold EDS to General Motors (GM) in 1984, but GM was unable to obtain any synergy with the purchase and spun off the company in 1996. EDS profits turned to losses during the technology downturn in 2000. The company eventually became profitable once again, but with smaller margins. EDS had been slow to respond to the threat of Indian rivals offering services at sharply lower prices. The company did increase its overseas hiring and bought control of MphasiS, an Indian services company. Since MphasiS was allowed to operate independently, with its own sales force and customer base, EDS did not gain much synergy from the acquisition. By 2008, EDS had 45,000 people working offshore and planned to hire more. Nevertheless, the best services companies had a large, low-cost workforce with tightly integrated operations so that employees with diverse skills could collaborate smoothly. This was the case with IBM, Accenture, and Indian companies like Tata Consultancy Services, but not with EDS or HP. Commenting on HP's purchase of EDS, N. Venkat Venktraman, chair of the Information Systems Department at Boston University's School of Management said, "The services sector is going through a shift, and this merger doesn't address the global service-delivery challenges that HP faces."

This case was written by J. David Hunger for *Strategic Management and Business Policy*, 12th edition and for *Concepts in Strategic Management and Business Policy*, 12th edition. Copyright © 2008 by J. David Hunger. Reprinted by permission.

Founded in 1940 by Dave Packard and Bill Hewlett in a garage in Palo Alto, California, Hewlett-Packard soon developed a reputation for making high-quality testing and measurement devices. Emphasizing their engineering roots, the two founders worked hard to develop the company's strong corporate culture. Their philosophy of managing became known as the "HP Way," composed of five basic values:

- We have trust and respect for individuals.
- We focus on a high level of achievement and contribution.
- We focus on a high level of business with uncompromising integrity.
- We achieve our common objectives through teamwork.
- We encourage flexibility and innovation.

These values continued to be emphasized by the CEOs following in the founder's footsteps. Until Carleton (Carly) Fiorina was hired as CEO in 1999, HP had been primarily known for its engineering excellence, but not for its marketing. For example, it developed the first handheld calculator, a quality product long cherished by engineers, but never developed or priced for the mass market. Fiorina lamented that Dell offered information technology products that were "low-tech and low cost; and IBM offered "high-tech and high cost," but HP was stuck somewhere in between them. She wanted to offer customers "high-tech and low cost" by improving the marketing of the company's outstanding products. During her tenure, HP acquired Compaq, the personal computer company. She also tried to buy the computer services unit of PriceWaterhouseCoopers in 2000, but lost out to IBM. Problems with integrating Compaq's middle-market orientation with HP's top-end orientation led to her firing by the board in 2005.

Fiorina was replaced by Mark Hurd, known to be a disciplined operations manager, who vowed to focus on implementation. Hurd had come to the company from Dayton, Ohio's NCR, where he had been President and CEO. Hurd dumped the matrix management structure initiated by Fiorina and gave responsibility back to the business unit managers. According to Hurd, "the more accountable I can make you, the easier it is for you to show you're a great performer. The more I use a matrix, the easier I make it to blame someone else." He also

broke up the centralized sales force and assigned sales people to each business unit. The SBUs now controlled over 70% of their own budget expenses, up from just 30% under Fiorina. Among other changes, Hurd hired executives from outside the company and cut costs by laying off 14,500 workers from a workforce of 150,000. Prith Banerjee, HP's new director of R&D, worked to make HP's famed research lab more efficient by cutting the number of projects from 150 to 20 or 30. Researchers would now be competing for money and manpower by proposing projects, complete with business plans to a central review board. Hurd knew that he had to make further changes to improve HP's competitive position. HP's corporate computing business seemed incapable of competing against IBM and Dell. Margins were slipping in the printer business, the source of 85% of HP's profits.

Hewlett-Packard was organized into three main groups: Imaging & Printing (27% of revenues), Personal Systems (35%), and Technology Solutions, which was composed of the Enterprise Storage & Servers segment (18%), HP Services segment (16%), and HP Software segment (2%). An additional business segment was Financial Services & Other (2% of revenues).

Even though Hurd was working hard to change the company by tightening up HP's operations, many of HP's middle managers still subscribed to the gentle, collegiate "HP Way." This culture fit the relaxed and casual style common to California's Silicon Valley and was part of the company's soul. People ate ahi tuna in the cafeteria. In contrast, EDS was founded in Plano, Texas, by the hard-charging entrepreneur, Ross Perot, who ran for U.S. president as an independent in 1992 and 1996. Reflecting Perot's no-nonsense style, the EDS corporate culture was military, buttoned-down, and staid. People wore ties and ate steak and fries in the EDS cafeteria.

One advantage of EDS was that it was the largest services firm that was independent of any hardware or software vendor. According to CEO Hurd, even though EDS would continue to advise clients to buy systems from all vendors, those clients would now be more likely to pay more attention when the boxes came from HP. Nevertheless, one disadvantage of the acquisition was the likely culture clash that would result from integrating EDS into HP's operations. Even though one analyst commented that Hurd's operations style made him "an EDS guy sitting on top of the HP Way," others wondered if the EDS acquisition would be as problematic as was the Compaq merger.

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PART 5

Introduction to Case Analysis

CHAPTER 12

suggestions for Case Analysis

Howard Schilit, founder of the Center for Financial Research & Analysis (CFRA), works with a staff of 15 analysts to screen financial databases and analyze public financial filings of 3,600 companies, looking for inconsistencies and aggressive accounting methods. Schilit calls this search for hidden weaknesses in a company's performance *forensic accounting*. "I'm like an investigative reporter," explains Schilit. "I'm interested in finding companies where the conventional wisdom is that they're very healthy, but if you dig a bit deeper, you find the emperor is not wearing the clothes you thought."[1] He advises anyone interested in analyzing a company to look deeply into its financial statements. For example, when the CFRA noticed that Kraft Foods made $122 million in acquisitions in 2002, but claimed $539 million as "goodwill" assets related to the purchases, it concluded that Kraft was padding its earnings with one-time gains. According to Schilit, unusually high goodwill gains related to recent acquisitions is a *red flag* that suggests an underlying problem.

Schilit proposes a short checklist of items to examine for red flags:

- **Cash flow from operations should exceed net income:** If cash flow from operations drops below net income, it could mean that the company is propping up its earnings by selling assets, borrowing cash, or shuffling numbers. Says Schilit, "You could have spotted the problems at Enron by just doing this."[2]
- **Accounts receivable should not grow faster than sales:** A firm facing slowing sales can make itself look better by inflating accounts receivable with expected future sales and by making sales to customers who are not credit worthy. "It's like mailing a contract to a dead person and then counting it as a sale," says Schilit.[3]
- **Gross margins should not fluctuate over time:** A change of more than 2% in either direction from year to year is worth a closer look. It could mean that the company is using other revenue, such as sales of assets or write-offs to boost profits. Sunbeam reported an increase of 10% in gross margins just before it was investigated by the SEC.
- **Examine carefully information about top management and the board:** When Schilit learned that the chairman of Checkers Restaurants had put his two young sons on the board, he warned investors of nepotism. Two years later, Checkers' huge debt caused its stock to fall 85% and all three family members were forced out of the company.

Learning Objectives

After reading this chapter, you should be able to:

- Research the case situation as needed
- Analyze financial statements by using ratios and common-size statements
- Use the strategic audit as a method of organizing and analyzing case information

- **Footnotes are important:** When companies change their accounting assumptions to make the statements more attractive, they often bury their rationale in the footnotes. Schilit dislikes companies that extend the depreciable life of their assets. "There's only one reason to do that—to add a penny or two to earnings—and it makes me very mistrustful of management."[4]

Schilit makes his living analyzing companies and selling his reports to investors. Annual reports and financial statements provide a lot of information about a company's health, but it's hard to find problem areas when management is massaging the numbers to make the company appear more attractive than it is. That's why Michelle Leder created her Web site, www.footnoted.org. She likes to highlight "the things that companies bury in their routine SEC filings."[5] This type of in-depth, investigative analysis is a key part of analyzing strategy cases. This chapter provides various analytical techniques and suggestions for conducting this kind of case analysis.

12.1 The Case Method

The analysis and discussion of case problems has been the most popular method of teaching strategy and policy for many years. The case method provides the opportunity to move from a narrow, specialized view that emphasizes functional techniques to a broader, less precise analysis of the overall corporation. Cases present actual business situations and enable you to examine both successful and unsuccessful corporations. In case analysis, you might be asked to critically analyze a situation in which a manager had to make a decision of long-term corporate importance. This approach gives you a feel for what it is like to face making and implementing strategic decisions.

12.2 Researching the Case Situation

You should not restrict yourself only to the information written in the case unless your instructor states otherwise. You should, if possible, undertake outside research about the environmental setting. Check the decision date of each case (typically the latest date mentioned in the case) to find out when the situation occurred and then screen the business periodicals for that time period. An understanding of the economy during that period will help you avoid making a serious error in your analysis, for example, suggesting a sale of stock when the stock market is at an all-time low or taking on more debt when the prime interest rate is over 15%. Information about the industry will provide insights into its competitive activities. *Important Note: Don't go beyond the decision date of the case in your research unless directed to do so by your instructor.*

Use computerized company and industry information services such as Compustat, Compact Disclosure, and CD/International, available on CD-ROM or online at the library. On the Internet, Hoover's OnLine Corporate Directory (www.hoovers.com) and the Security Exchange Commission's Edgar database (www.sec.gov) provide access to corporate annual reports and 10-K forms. This background will give you an appreciation for the situation as it was experienced by the participants in the case. Use a search engine such as Google to find additional information about the industry and the company.

A company's **annual report** and **SEC 10-K form** from the year of the case can be very helpful. According to the Yankelovich Partners survey firm, 8 out of 10 portfolio managers and 75% of security analysts use annual reports when making decisions.[6] They contain not only the usual income statements and balance sheets, but also cash flow statements and notes to the financial statements indicating why certain actions were taken. 10-K forms include detailed information not usually available in an annual report. **SEC 10-Q forms** include quarterly financial reports. **SEC 14-A forms** include detailed information on members of a company's board of directors and proxy statements for annual meetings. Some resources available for research into the economy and a corporation's industry are suggested in **Appendix 12.A**.

A caveat: Before obtaining additional information about the company profiled in a particular case, ask your instructor if doing so is appropriate for your class assignment. Your strategy instructor may want you to stay within the confines of the case information provided in the book. In this case, it is usually acceptable to at least learn more about the societal environment at the time of the case.

12.3 Financial Analysis: A Place to Begin

Once you have read a case, a good place to begin your analysis is with the financial statements. **Ratio analysis** is the calculation of ratios from data in these statements. It is done to identify possible financial strengths or weaknesses. Thus it is a valuable part of SWOT analysis. A review of key financial ratios can help you assess a company's overall situation and pinpoint some problem areas. Ratios are useful regardless of firm size and enable you to compare a company's ratios with industry averages. **Table 12–1** lists some of the most important financial ratios, which are (1) **liquidity ratios**, (2) **profitability ratios**, (3) **activity ratios**, and (4) **leverage ratios**.

TABLE 12–1 Financial Ratio Analysis

	Formula	How Expressed	Meaning
1. Liquidity Ratios			
Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Decimal	A short-term indicator of the company's ability to pay its short-term liabilities from short-term assets; how much of current assets are available to cover each dollar of current liabilities.
Quick (acid test) ratio	$\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$	Decimal	Measures the company's ability to pay off its short-term obligations from current assets, excluding inventories.
Inventory to net working capital	$\frac{\text{Inventory}}{\text{Current assets} - \text{Current liabilities}}$	Decimal	A measure of inventory balance; measures the extent to which the cushion of excess current assets over current liabilities may be threatened by unfavorable changes in inventory.
Cash ratio	$\frac{\text{Cash} + \text{Cash equivalents}}{\text{Current liabilities}}$	Decimal	Measures the extent to which the company's capital is in cash or cash equivalents; shows how much of the current obligations can be paid from cash or near-cash assets.
2. Profitability Ratios			
Net profit margin	$\frac{\text{Net profit after taxes}}{\text{Net sales}}$	Percentage	Shows how much after-tax profits are generated by each dollar of sales.
Gross profit margin	$\frac{\text{Sales} - \text{Cost of goods sold}}{\text{Net sales}}$	Percentage	Indicates the total margin available to cover other expenses beyond cost of goods sold and still yield a profit.
Return on investment (ROI)	$\frac{\text{Net profit after taxes}}{\text{Total assets}}$	Percentage	Measures the rate of return on the total assets utilized in the company; a measure of management's efficiency, it shows the return on all the assets under its control, regardless of source of financing.
Return on equity (ROE)	$\frac{\text{Net profit after taxes}}{\text{Shareholders' equity}}$	Percentage	Measures the rate of return on the book value of shareholders' total investment in the company.
Earnings per share (EPS)	$\frac{\text{Net profit after taxes} - \text{Preferred stock dividends}}{\text{Average number of common shares}}$	Dollars per share	Shows the after-tax earnings generated for each share of common stock.
3. Activity Ratios			
Inventory turnover	$\frac{\text{Net sales}}{\text{Inventory}}$	Decimal	Measures the number of times that average inventory of finished goods was turned over or sold during a period of time, usually a year.
Days of inventory	$\frac{\text{Inventory}}{\text{Cost of goods sold} \div 365}$	Days	Measures the number of one day's worth of inventory that a company has on hand at any given time.

continued

TABLE 12–1 Financial Ratio Analysis, (continued)

	Formula	How Expressed	Meaning
Net working capital turnover	$\frac{\text{Net sales}}{\text{Net working capital}}$	Decimal	Measures how effectively the net working capital is used to generate sales.
Asset turnover	$\frac{\text{Sales}}{\text{Total assets}}$	Decimal	Measures the utilization of all the company's assets; measures how many sales are generated by each dollar of assets.
Fixed asset turnover	$\frac{\text{Sales}}{\text{Fixed assets}}$	Decimal	Measures the utilization of the company's fixed assets (i.e., plant and equipment); measures how many sales are generated by each dollar of fixed assets.
Average collection period	$\frac{\text{Accounts receivable}}{\text{Sales for year} \div 365}$	Days	Indicates the average length of time in days that a company must wait to collect a sale after making it; may be compared to the credit terms offered by the company to its customers.
Accounts receivable turnover	$\frac{\text{Annual credit sales}}{\text{Accounts receivable}}$	Decimal	Indicates the number of times that accounts receivable are cycled during the period (usually a year).
Accounts payable period	$\frac{\text{Accounts payable}}{\text{Purchases for year} \div 365}$	Days	Indicates the average length of time in days that the company takes to pay its credit purchases.
Days of cash	$\frac{\text{Cash}}{\text{Net sales for year} \div 365}$	Days	Indicates the number of days of cash on hand, at present sales levels.
4. Leverage Ratios			
Debt to asset ratio	$\frac{\text{Total debt}}{\text{Total assets}}$	Percentage	Measures the extent to which borrowed funds have been used to finance the company's assets.
Debt to equity ratio	$\frac{\text{Total debt}}{\text{Shareholders' equity}}$	Percentage	Measures the funds provided by creditors versus the funds provided by owners.
Long-term debt to capital structure	$\frac{\text{Long-term debt}}{\text{Shareholders' equity}}$	Percentage	Measures the long-term component of capital structure.
Times interest earned	$\frac{\text{Profit before taxes} + \text{Interest charges}}{\text{Interest charges}}$	Decimal	Indicates the ability of the company to meet its annual interest costs.
Coverage of fixed charges	$\frac{\text{Profit before taxes} + \text{Interest charges} + \text{Lease charges}}{\text{Interest charges} + \text{Lease obligations}}$	Decimal	A measure of the company's ability to meet all of its fixed-charge obligations.
Current liabilities to equity	$\frac{\text{Current liabilities}}{\text{Shareholders' equity}}$	Percentage	Measures the short-term financing portion versus that provided by owners.

TABLE 12–1 Financial Ratio Analysis, (continued)

	Formula	How Expressed	Meaning
5. Other Ratios Price/earnings ratio	$\frac{\text{Market price per share}}{\text{Earnings per share}}$	Decimal	Shows the current market's evaluation of a stock, based on its earnings; shows how much the investor is willing to pay for each dollar of earnings.
Divided payout ratio	$\frac{\text{Annual dividends per share}}{\text{Annual earnings per share}}$	Percentage	Indicates the percentage of profit that is paid out as dividends.
Dividend yield on common stock	$\frac{\text{Annual dividends per share}}{\text{Current market price per share}}$	Percentage	Indicates the dividend rate of return to common shareholders at the current market price.

NOTE: In using ratios for analysis, calculate ratios for the corporation and compare them to the average and quartile ratios for the particular industry. Refer to Standard & Poor's and Robert Morris Associates for average industry data. Special thanks to Dr. Moustafa H. Abdelsamad, Dean, Business School, Texas A&M University—Corpus Christi, Corpus Christi, Texas, for his definitions of these ratios.

ANALYZING FINANCIAL STATEMENTS

In your analysis, do not simply make an exhibit that includes all the ratios (unless your instructor requires you to do so), but select and discuss only those ratios that have an impact on the company's problems. For instance, accounts receivable and inventory may provide a source of funds. If receivables and inventories are double the industry average, reducing them may provide needed cash. In this situation, the case report should include not only sources of funds but also the number of dollars freed for use. Compare these ratios with industry averages to discover whether the company is out of line with others in the industry. Annual and quarterly industry ratios can be found in the library or on the Internet. (See the resources for case research in **Appendix 12.A.**) In the years to come, expect to see financial entries for the trading of CERs (Certified Emissions Reductions). This is the amount of money a company earns from reducing carbon emissions and selling them on the open market. To learn how carbon trading is likely to affect corporations, see the **Environmental Sustainability Issue**.

A typical financial analysis of a firm would include a study of the operating statements for five or so years, including a trend analysis of sales, profits, earnings per share, debt-to-equity ratio, return on investment, and so on, plus a ratio study comparing the firm under study with industry standards. As a minimum, undertake the following five steps in basic financial analysis.

1. **Scrutinize historical income statements and balance sheets:** These two basic statements provide most of the data needed for analysis. Statements of cash flow may also be useful.
2. **Compare historical statements over time** if a series of statements is available.
3. **Calculate changes that occur in individual categories from year to year,** as well as the cumulative total change.
4. **Determine the change as a percentage** as well as an absolute amount.
5. **Adjust for inflation** if that was a significant factor.

Examination of this information may reveal developing trends. Compare trends in one category with trends in related categories. For example, an increase in sales of 15% over three years may appear to be satisfactory until you note an increase of 20% in the cost of goods sold

ENVIRONMENTAL sustainability issue

IMPACT OF CARBON TRADING

Do you know about carbon trading, emissions allowances, cap-and-trade, or CERs? These are terms you can expect to hear a lot more in the years to come. The concept of carbon trading is something that will soon be affecting the balance sheets and income statements of all corporations, especially those with international operations. It is one way to account for environmental sustainability initiatives.

The Kyoto Protocol established an emissions trading program that assigned annual limits on greenhouse gases emitted by facilities within each country's boundaries. The countries signing the pact, including Canada, Japan, and the European Union, were then able to trade emission surpluses and deficits with each other. In addition, individual countries or companies could invest in projects in developing nations that would reduce emissions and use those reductions to meet their own targets.

In 2005 the European Union initiated a trading system allowing individual facilities to sell credit allowances they had earned for reducing greenhouse gas emissions. It created a tradable commodity, the Certified Emissions Reduction (CER), which gave a facility the right to emit one metric ton of carbon dioxide annually. The CER was created by another facility that reduced its carbon dioxide emissions. (Reducing or trapping one metric ton of methane from entering the atmosphere was worth 21 CERs due to methane's greater impact on global warming.) By 2006, a CER traded on the European market for around 25 euros with trading volume totaling one million CERs per day. Barclays, Citibank, Credit Suisse, HSBC, Lehman Brothers, and Morgan Stanley soon opened trading desks for CERs at London's Canary Wharf, the global center for carbon trading. By 2007, European and Asian traders bought and sold approximately $60 billion worth of emission CERs.

Carbon trading has created an opportunity for new and established companies. For example, Mission Point Capital Partners is one of more than 50 private equity and hedge funds specializing in carbon finance and clean energy. Mission Point created a joint venture in 2008 with GE and AES to develop large volumes of emissions credits. These would be sold to U.S. companies like Yahoo! and News Corp that wanted to become carbon neutral by offsetting their carbon emissions. Assuming that the U.S. federal government would soon establish a cap-and-trade market for emissions, the joint venture partners expected to produce 10 million tons of emission credits by 2010. According to Kevin Walsh, managing director of GE Energy Financial Services, "We think this is going to be an enormous market."

SOURCE: A. White, "Environment: The Greening of the Balance Sheet," *Harvard Business Review* (March 2006), pp. 27–28; M. Gunther, "Carbon Finance Comes of Age," *Fortune* (April 28, 2008), pp. 124–132.

during the same period. The outcome of this comparison might suggest that further investigation into the manufacturing process is necessary. If a company is reporting strong net income growth but negative cash flow, this would suggest that the company is relying on something other than operations for earnings growth. Is it selling off assets or cutting R&D? If accounts receivable are growing faster than sales revenues, the company is not getting paid for the products or services it is counting as sold. Is the company dumping product on its distributors at the end of the year to boost its reported annual sales? If so, expect the distributors to return the unordered product the next month, thus drastically cutting the next year's reported sales.

Other "tricks of the trade" need to be examined. Until June 2000, firms growing through acquisition were allowed to account for the cost of the purchased company, through the pooling of both companies' stock. This approach was used in 40% of the value of mergers between 1997 and 1999. The pooling method enabled the acquiring company to disregard the premium it paid for the other firm (the amount above the fair market value of the purchased company often called "good will"). Thus, when PepsiCo agreed to purchase Quaker Oats for $13.4 billion in PepsiCo stock, the $13.4 billion was not found on PepsiCo's balance sheet. As of June 2000, merging firms must use the "purchase" accounting rules in which the true purchase price is reflected in the financial statements.[7]

GLOBAL issue

FINANCIAL STATEMENTS OF MULTINATIONAL CORPORATIONS: NOT ALWAYS WHAT THEY SEEM

A multinational corporation follows the accounting rules for its home country. As a result, its financial statements may be somewhat difficult to understand or to use for comparisons with competitors from other countries. For example, British firms such as British Petroleum use the term *turnover* rather than *sales revenue*. In the case of AB Electrolux of Sweden, a footnote to an annual report indicates that the consolidated accounts have been prepared in accordance with Swedish accounting standards, which differ in certain significant respects from U.S. generally accepted accounting principles (U.S. GAAP). For one year, net income of 4,830m SEK (Swedish kronor) approximated 5,655m SEK according to U.S. GAAP. Total assets for the same period were 84,183m SEK according to Swedish principle, but 86,658m according to U.S. GAAP.

The analysis of a multinational corporation's financial statements can get very complicated, especially if its headquarters is in another country that uses different accounting standards. See the **Global Issue** for why financial analysis can get tricky at times.

COMMON-SIZE STATEMENTS

Common-size statements are income statements and balance sheets in which the dollar figures have been converted into percentages. These statements are used to identify trends in each of the categories, such as cost of goods sold as a percentage of sales (sales is the denominator). For the income statement, net sales represent 100%: calculate the percentage for each category so that the categories sum to the net sales percentage (100%). For the balance sheet, give the total assets a value of 100% and calculate other asset and liability categories as percentages of the total assets with total assets as the denominator. (Individual asset and liability items, such as accounts receivable and accounts payable, can also be calculated as a percentage of net sales.)

When you convert statements to this form, it is relatively easy to note the percentage that each category represents of the total. Look for trends in specific items, such as cost of goods sold, when compared to the company's historical figures. To get a proper picture, however, you need to make comparisons with industry data, if available, to see whether fluctuations are merely reflecting industry-wide trends. If a firm's trends are generally in line with those of the rest of the industry, problems are less likely than if the firm's trends are worse than industry averages. If ratios are not available for the industry, calculate the ratios for the industry's best and worst firms and compare them to the firm you are analyzing. Common-size statements are especially helpful in developing scenarios and pro forma statements because they provide a series of historical relationships (for example, cost of goods sold to sales, interest to sales, and inventories as a percentage of assets) from which you can estimate the future with your scenario assumptions for each year.

Z-VALUE AND INDEX OF SUSTAINABLE GROWTH

If the corporation being studied appears to be in poor financial condition, use **Altman's Z-Value Bankruptcy Formula** to calculate its likelihood of going bankrupt. The *Z-value* formula

combines five ratios by weighting them according to their importance to a corporation's financial strength. The formula is:

$$Z = 1.2x_1 + 1.4x_2 + 3.3x_3 + 0.6x_4 + 1.0x_5$$

where:

x_1 = Working capital/Total assets (%)
x_2 = Retained earnings/Total assets (%)
x_3 = Earnings before interest and taxes/Total assets (%)
x_4 = Market value of equity/Total liabilities (%)
x_5 = Sales/Total assets (number of times)

A score below 1.81 indicates significant credit problems, whereas a score above 3.0 indicates a healthy firm. Scores between 1.81 and 3.0 indicate question marks.[8] The Altman Z model has achieved a remarkable 94% accuracy in predicting corporate bankruptcies. Its accuracy is excellent in the two years before financial distress, but diminishes as the lead time increases.[9]

The **index of sustainable growth** is useful to learn whether a company embarking on a growth strategy will need to take on debt to fund this growth. The index indicates how much of the growth rate of sales can be sustained by internally generated funds. The formula is:

$$g^* = \frac{[P(1 - D)(1 + L)]}{[T - P(1 - D)(1 + L)]}$$

where:

P = (Net profit before tax/Net sales)×100
D = Target dividends/Profit after tax
L = Total liabilities/Net worth
T = (Total assets/Net sales)×100

If the planned growth rate calls for a growth rate higher than its g*, external capital will be needed to fund the growth unless management is able to find efficiencies, decrease dividends, increase the debt-equity ratio, or reduce assets through renting or leasing arrangements.[10]

USEFUL ECONOMIC MEASURES

If you are analyzing a company over many years, you may want to adjust sales and net income for inflation to arrive at "true" financial performance in constant dollars. **Constant dollars** are dollars adjusted for inflation to make them comparable over various years. One way to adjust for inflation in the United States is to use the Consumer Price Index (CPI), as given in **Table 12–2.** Dividing sales and net income by the CPI factor for that year will change the figures to 1982–1984 U.S. constant dollars (when the CPI was 1.0). Adjusting for inflation is especially important for companies operating in the emerging economies, like China and Russia, where inflation in 2008 rose to 6.6%, the highest in 10 years. In that same year, Zimbabwe's inflation rate was the highest in the world at 2.2 million%![11]

Another helpful analytical aid provided in **Table 12–2** is the **prime interest rate**, the rate of interest banks charge on their lowest-risk loans. For better assessments of strategic decisions, it can be useful to note the level of the prime interest rate at the time of the case. A decision to borrow money to build a new plant would have been a good one in 2003 at 4.1% but less practical in 2007 when the average rate was 8.1%.

TABLE 12–2

U.S. Economic Indicators

Year	GDP (in $ billions) Gross Domestic Product	CPI (for all items) Consumer Price Index	PIR (in %) Prime Interest Rate
1980	2,789.5	.824	15.27
1985	4,220.3	1.076	9.93
1990	5,803.1	1.307	10.01
1995	7,397.7	1.524	8.83
1996	7,816.9	1.569	8.27
1997	8,304.3	1.605	8.44
1998	8,747.0	1.630	8.35
1999	9,268.4	1.666	7.99
2000	9,817.0	1.722	9.23
2001	10,128.0	1.771	6.92
2002	10,469.6	1.799	4.68
2003	10,960.8	1.840	4.12
2004	11,685.9	1.889	4.29
2005	12,421.9	1.953	6.10
2006	13,178.4	2.016	7.94
2007	13,807.5	2.073	8.08
2008	14,280.7	2.153	5.21

NOTES: Gross Domestic Product (GDP) in Billions of Dollars; Consumer Price Index for All Items (CPI) (1982–84 = 1.0); Prime Interest Rate (PIR) in Percentages.

SOURCES: Gross Domestic Product (GDP) from U.S. Bureau of Economic Analysis, National Economic Accounts (www.bea.gov). Consumer Price Index (CPI) from U.S. Bureau of Labor Statistics (www.bls.gov). Prime Interest Rate (PIR) from www.moneycafe.com.

In preparing a scenario for your pro forma financial statements, you may want to use the **gross domestic product (GDP)** from **Table 12–2**. GDP is used worldwide and measures the total output of goods and services within a country's borders. The amount of change from one year to the next indicates how much that country's economy is growing. Remember that scenarios have to be adjusted for a country's specific conditions. For other economic information, see the resources for case research in **Appendix 12.A**.

12.4 Format for Case Analysis: The Strategic Audit

There is no one best way to analyze or present a case report. Each instructor has personal preferences for format and approach. Nevertheless, in **Appendix 12.B** we suggest an approach for both written and oral reports that provides a systematic method for successfully attacking a case. This approach is based on the strategic audit, which is presented at the end of **Chapter 1** in **Appendix 1.A**). We find that this approach provides structure and is very helpful for the typical student who may be a relative novice in case analysis. Regardless of the format chosen, be careful to include a complete analysis of key environmental variables—especially of trends in the industry and of the competition. Look at international developments as well.

If you choose to use the strategic audit as a guide to the analysis of complex strategy cases, you may want to use the **strategic audit worksheet** in **Figure 12–1**. Print a copy of the worksheet to use to take notes as you analyze a case. See **Appendix 12.C** for an example of a completed student-written analysis of a 1993 Maytag Corporation case done in an outline form

FIGURE 12–1
Strategic Audit Worksheet

Strategic Audit Heading	Analysis (+) Factors	Analysis (–) Factors	Comments
I. Current Situation			
A. Past Corporate Performance Indexes			
B. Strategic Posture: Current Mission Current Objectives Current Strategies Current Policies			
SWOT Analysis Begins:			
II. Corporate Governance			
A. Board of Directors			
B. Top Management			
III. External Environment (EFAS): Opportunities and Threats (SWOT)			
A. Natural Environment			
B. Societal Environment			
C. Task Environment (Industry Analysis)			
IV. Internal Environment (IFAS): Strengths and Weaknesses (SWOT)			
A. Corporate Structure			
B. Corporate Culture			
C. Corporate Resources			
1. Marketing			
2. Finance			
3. Research and Development			
4. Operations and Logistics			
5. Human Resources			
6. Information Technology			
V. Analysis of Strategic Factors (SFAS)			
A. Key Internal and External Strategic Factors (SWOT)			
B. Review of Mission and Objectives			
SWOT Analysis Ends. Recommendation Begins:			
VI. Alternatives and Recommendations			
A. Strategic Alternatives—pros and cons			
B. Recommended Strategy			
VII. Implementation			
VIII. Evaluation and Control			

NOTE: See the complete Strategic Audit on pages 34–41. It lists the pages in the book that discuss each of the eight headings.

SOURCE: T. L. Wheelen and J. D. Hunger, "Strategic Audit Worksheet." Copyright © 1985, 1986, 1987, 1988, 1989, 2005, and 2009 by T. L. Wheelen. Copyright © 1989, 2005, and 2009 by Wheelen and Hunger Associates. Revised 1991, 1994, and 1997. Reprinted by permission. Additional copies available for classroom use in Part D of *Case Instructors Manual* and on the Prentice Hall Web site (www.prenhall.com/wheelen).

using the strategic audit format. This is one example of what a case analysis in outline form may look like.

Case discussion focuses on critical analysis and logical development of thought. A solution is satisfactory if it resolves important problems and is likely to be implemented successfully. How the corporation actually dealt with the case problems has no real bearing on the analysis because management might have analyzed its problems incorrectly or implemented a series of flawed solutions.

End of Chapter SUMMARY

Using case analysis is one of the best ways to understand and remember the strategic management process. By applying to cases the concepts and techniques you have learned, you will be able to remember them long past the time when you have forgotten other memorized bits of information. The use of cases to examine actual situations brings alive the field of strategic management and helps build your analytic and decision-making skills. These are just some of the reasons why the use of cases in disciplines from agribusiness to health care is increasing throughout the world.

ECO-BITS

- A 2007 McKinsey & Company survey of 7,751 people in eight countries found that 87% of consumers worry about the environment and the social impact of the products they buy.
- The same 2007 survey found that only 33% of the consumers said that they were ready to buy green products or had already done so.
- In a 2007 *Chain Store Age* survey of U.S. consumers, only 25% of them had bought any green products other than organic food or energy-efficient lighting.[12]

DISCUSSION QUESTIONS

1. Why should you begin a case analysis with a financial analysis? When are other approaches appropriate?
2. What are common-size financial statements? What is their value to case analysis? How are they calculated?
3. When should you gather information outside a case by going to the library or using the Internet? What should you look for?
4. When is inflation an important issue in conducting case analysis? Why bother?
5. How can you learn what date a case took place?

STRATEGIC PRACTICE EXERCISE

Convert the following two years of income statements from the Maytag Corporation into common-size statements. The dollar figures are in thousands. What does converting to a common size reveal?

Consolidated Statements of Income: Maytag Corporation

	1992	%	1991	%
Net sales	$3,041,223	100	$2,970,626	100
Cost of sales	2,339,406	—	2,254,221	—
Gross profits	701,817	—	716,405	—
Selling, general, & admin. expenses	528,250	—	524,898	—
Reorganization expenses	95,000	—	0	—
Operating income	78,567	—	191,507	—
Interest expense	(75,004)	—	(75,159)	—
Other—net	3,983	—	7,069	—
Income before taxes and accounting changes	7,546	—	123,417	—
Income taxes	(15,900)	—	(44,400)	—
Income before accounting changes	(8,354)	—	79,017	—
Effects of accounting changes for postretirement benefits	(307,000)	—	0	—
Net income (loss)	$(315,354)	—	$79,017	—

KEY TERMS

activity ratio (p. 366)
Altman's Z-Value Bankruptcy Formula (p. 371)
annual report (p. 366)
common-size statement (p. 371)
constant dollars (p. 372)
gross domestic product (GDP) (p. 373)
index of sustainable growth (p. 372)
leverage ratio (p. 366)
liquidity ratio (p. 366)
prime interest rate (p. 372)
profitability ratio (p. 366)
ratio analysis (p. 366)
SEC 10-K form (p. 366)
SEC 10-Q form (p. 366)
SEC 14-A form (p. 366)
strategic audit worksheet (p. 373)

NOTES

1. M. Heimer, "Wall Street Sherlock," *Smart Money* (July 2003), pp. 103–107.
2. *Ibid.*, p. 105.
3. *Ibid.*, p. 105.
4. *Ibid.*, p. 105.
5. D. Stead, "The Secrets in SEC Filings," *Business Week* (September 1, 2008), p. 12.
6. M. Vanac, "What's a Novice Investor to Do?" *Des Moines Register* (November 30, 1997), p. 3G.
7. A. R. Sorking, "New Path on Mergers Could Contain Loopholes," *The* (Ames, IA) *Daily Tribune* (January 9, 2001), p. B7; "Firms Resist Effort to Unveil True Costs of Doing Business," *USA Today* (July 3, 2000), p. 10A.
8. M. S. Fridson, *Financial Statement Analysis* (New York: John Wiley & Sons, 1991), pp. 192–194.
9. E. I. Altman, "Predicting Financial Distress of Companies: Revisiting the Z-Score and Zeta Models," Working paper at http://pages.stern.nyu.edu/~ealtman/Zscores.pdf (July 2000).
10. D. H. Bangs, *Managing by the Numbers* (Dover, N.H.: Upstart Publications, 1992), pp. 106–107.
11. "Economic Focus: A Tale of Two Worlds," *The Economist* (May 10, 2008), p. 88; "Zimbabwe: A Worthless Currency," *The Economist* (July 19, 2008), pp. 56–57.
12. S. M. J. Bonini and J. M. Oppenheim, "Helping 'Green' Products Grow," *McKinsey Quarterly* (October 2008), pp. 1–8.

APPENDIX 12.A

Resources for Case Research

Company Information

1. Annual reports
2. Moody's *Manuals on Investment* (a listing of companies within certain industries that contains a brief history and a five-year financial statement of each company)
3. Securities and Exchange Commission Annual Report Form 10-K (annually) and 10-Q (quarterly)
4. Standard & Poor's *Register of Corporations, Directors, and Executives*
5. Value Line's *Investment Survey*
6. Findex's *Directory of Market Research Reports, Studies and Surveys* (a listing by Find/SVP of more than 11,000 studies conducted by leading research firms)
7. Compustat, Compact Disclosure, CD/International, and Hoover's Online Corporate Directory (computerized operating and financial information on thousands of publicly held corporations)
8. Shareholders meeting notices in SEC Form 14-A (proxy notices)

Economic Information

1. Regional statistics and local forecasts from large banks
2. *Business Cycle Development* (Department of Commerce)
3. Chase Econometric Associates' publications
4. U.S. Census Bureau publications on population, transportation, and housing
5. *Current Business Reports* (U.S. Department of Commerce)
6. *Economic Indicators* (U.S. Joint Economic Committee)
7. *Economic Report of the President to Congress*
8. *Long-Term Economic Growth* (U.S. Department of Commerce)
9. *Monthly Labor Review* (U.S. Department of Labor)
10. *Monthly Bulletin of Statistics* (United Nations)
11. *Statistical Abstract of the United States* (U.S. Department of Commerce)
12. *Statistical Yearbook* (United Nations)
13. *Survey of Current Business* (U.S. Department of Commerce)
14. *U.S. Industrial Outlook* (U.S. Department of Defense)
15. *World Trade Annual* (United Nations)
16. *Overseas Business Reports* (by country, published by the U.S. Department of Commerce)

Industry Information

1. Analyses of companies and industries by investment brokerage firms
2. *Business Week* (provides weekly economic and business information, as well as quarterly profit and sales rankings of corporations)

3. *Fortune* (each April publishes listings of financial information on corporations within certain industries)
4. *Industry Survey* (published quarterly by Standard & Poor's)
5. *Industry Week* (late March/early April issue provides information on 14 industry groups)
6. *Forbes* (mid-January issue provides performance data on firms in various industries)
7. *Inc.* (May and December issues give information on fast-growing entrepreneurial companies)

Directory and Index Information on Companies and Industries

1. *Business Periodical Index* (on computers in many libraries)
2. *Directory of National Trade Associations*
3. *Encyclopedia of Associations*
4. Funk and Scott's *Index of Corporations and Industries*
5. Thomas' *Register of American Manufacturers*
6. *Wall Street Journal Index*

Ratio Analysis Information

1. *Almanac of Business and Industrial Financial Ratios* (Prentice Hall)
2. *Annual Statement Studies* (Risk Management Associates; also Robert Morris Associates)
3. *Dun's Review* (Dun & Bradstreet; published annually in September–December issues)
4. *Industry Norms and Key Business Ratios* (Dun & Bradstreet)

Online Information

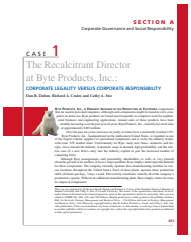
1. *Hoover's Online*—financial statements and profiles of public companies (www.hoovers.com)
2. U.S. Securities and Exchange Commission—official filings of public companies in Edgar database (www.sec.gov)
3. Fortune 500—statistics for largest U.S. corporations (www.fortune.com)
4. Dun & Bradstreet's Online—short reports on 10 million public and private U.S. companies (smallbusiness.dnb.com)
5. Ecola's 24-Hour Newsstand—links to Web sites of 2,000 newspapers, journals, and magazines (www.ecola.com)
6. Competitive Intelligence Guide—information on company resources (www.fuld.com)
7. Society of Competitive Intelligence Professionals (www.scip.org)
8. *The Economist*—provides international information and surveys (www.economist.com)
9. *CIA World Fact Book*—international information by country (http://www.cia.gov)
10. Bloomberg—information on interest rates, stock prices, currency conversion rates, and other general financial information (www.bloomberg.com)
11. The Scannery—information on international companies (www.thescannery.com)
12. CEOExpress—links to many valuable sources of business information (www.ceoexpress.com)
13. *Wall Street Journal*—business news (www.wsj.com)
14. Forbes—America's largest private companies (http://www.forbes.com/lists/)
15. CorporateInformation.com—subscription service for company profiles (www.corporateinformation.com)
16. Kompass International—industry information (www.kompass.com)
17. CorpTech—database of technology companies (www.corptech.com)
18. ADNet—information technology industry (www.companyfinder.com)
19. CNN company research—provides company information (http://money.cnn.com/news/crc/)

20. Paywatch—database of executive compensation (http://www.aflcio.org/corporatewatch/paywatch/)
21. Global Edge Global Resources—international resources (http://globaledge.msu.edu/resourceDesk/)
22. Google Finance—data on North American stocks (http://finance.google.com/finance)
23. World Federation of Exchanges—international stock exchanges (www.world-exchanges.org/)
24. SEC International Registry—data on international corporations (http://www.sec.gov/divisions/corpfin/internatl/companies.shtml)
25. Yahoo Finance—data on North American companies (http://finance.yahoo.com)

APPENDIX 12.B

Suggested Case Analysis Methodology Using the Strategic Audit

1. READ CASE


SECTION A
Corporate Governance and Social Responsibility

CASE 1
The Recalcitrant Director at Byte Products, Inc.:
CORPORATE LEGALITY VERSUS CORPORATE RESPONSIBILITY

First Reading of the Case

- Develop a general overview of the company and its external environment.
- Begin a list of the possible strategic factors facing the company at this time.
- List the research information you may need on the economy, industry, and competitors.

2. READ THE CASE WITH THE STRATEGIC AUDIT

Second Reading of the Case

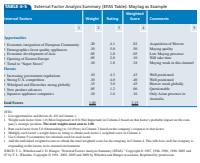
- Read the case a second time, using the strategic audit as a framework for in-depth analysis. (See **Appendix 1.A** on pages 34–41.) You may want to make a copy of the strategic audit worksheet (**Figure 12–1**) to use to keep track of your comments as you read the case.
- The questions in the strategic audit parallel the strategic decision-making process shown in **Figure 1–5** (pages 28–29).
- The audit provides you with a conceptual framework to examine the company's mission, objectives, strategies, and policies as well as problems, symptoms, facts, opinions, and issues.
- Perform a financial analysis of the company, using ratio analysis (see **Table 12–1**), and do the calculations necessary to convert key parts of the financial statements to a common-size basis.

3. DO OUTSIDE RESEARCH

Library and Online Computer Services

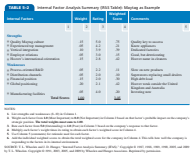
- Each case has a decision date indicating when the case actually took place. Your research should be based on the time period for the case.
- See **Appendix 12.A** for resources for case research. Your research should include information about the environment at the time of the case. Find average industry ratios. You may also want to obtain further information regarding competitors and the company itself (10-K forms and annual reports). This information should help you conduct an industry analysis. *Check with your instructor to see what kind of outside research is appropriate for your assignment.*
- Don't try to learn what actually happened to the company discussed in the case. What management actually decided may not be the best solution. It will certainly bias your analysis and will probably cause your recommendation to lack proper justification.

4. BEGIN SWOT ANALYSIS



External Environmental Analysis: EFAS

- Analyze the natural and societal environments to see what general trends are likely to affect the industry(s) in which the company is operating.
- Conduct an industry analysis using Porter's competitive forces from **Chapter 4.** Develop an Industry Matrix (**Table 4–4** on page 119).
- Generate 8 to 10 external factors. These should be the *most important* opportunities and threats facing the company at the time of the case.
- Develop an EFAS Table, as shown in **Table 4–5** (page 126), for your list of external strategic factors.
- **Suggestion:** Rank the 8 to 10 factors from most to least important. Start by grouping the 3 top factors and then the 3 bottom factors.



Internal Organizational Analysis: IFAS

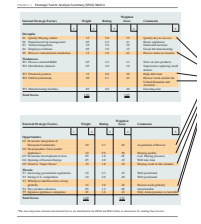
- Generate 8 to 10 internal factors. These should be the *most important* strengths and weaknesses of the company at the time of the case.
- Develop an IFAS Table, as shown in **Table 5–2** (page 164), for your list of internal strategic factors.
- **Suggestion:** Rank the 8 to 10 factors from most to least important. Start by grouping the 3 top factors and then the 3 bottom factors.

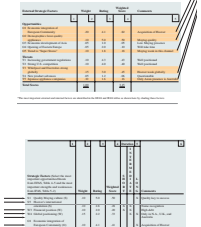
5. WRITE YOUR STRATEGIC AUDIT: PARTS I TO IV

First Draft of Your Strategic Audit

- Review the student-written audit of an old Maytag case in **Appendix 12.C** for an example.
- Write Parts I to IV of the strategic audit. Remember to include the factors from your EFAS and IFAS Tables in your audit.

6. WRITE YOUR STRATEGIC AUDIT: PART V





Strategic Factor Analysis Summary: SFAS

- **Condense the list of factors from the 16 to 20 identified in your EFAS and IFAS Tables to only the 8 to 10 most important factors.**
- Select the most important EFAS and IFAS factors. Recalculate the weights of each. The weights still need to add to 1.0.
- Develop a SFAS Matrix, as shown in **Figure 6–1** (page 178), for your final list of strategic factors. Although the weights (indicating the importance of each factor) will probably change from the EFAS and IFAS Tables, the numeric rating (1 to 5) of each factor should remain the same. These ratings are your assessment of management's performance on each factor.
- This is a good time to reexamine what you wrote earlier in Parts I to IV. You may want to add to or delete some of what you wrote. Ensure that each one of the strategic factors you have included in your SFAS Matrix is discussed in the appropriate place in Parts I to IV. Part V of the audit is *not* the place to mention a strategic factor for the first time.
- Write Part V of your strategic audit. This completes your SWOT analysis.
- This is the place to suggest a revised mission statement and a better set of objectives for the company. The SWOT analysis coupled with revised mission and objectives for the company set the stage for the generation of strategic alternatives.

7. WRITE YOUR STRATEGIC AUDIT: PART VI

Strategic Alternatives and Recommendation

A. Alternatives

- Develop around three mutually exclusive strategic alternatives. If appropriate to the case you are analyzing, you might propose one alternative for growth, one for stability, and one for retrenchment. Within each corporate strategy, you should probably propose an appropriate business/competitive strategy. You may also want to include some functional strategies where appropriate.
- Construct a corporate scenario for each alternative. Use the data from your outside research to project general societal trends (GDP, inflation, and etc.) and industry trends. Use these as the basis of your assumptions to write pro forma financial statements (particularly income statements) for each strategic alternative for the next five years.
- List pros and cons for each alternative based on your scenarios.

B. Recommendation

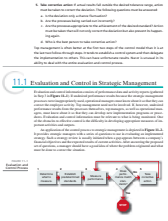
- Specify which one of your alternative strategies you recommend. Justify your choice in terms of dealing with the strategic factors you listed in Part V of the strategic audit.
- Develop policies to help implement your strategies.

8. WRITE YOUR STRATEGIC AUDIT: PART VII

Implementation

- Develop programs to implement your recommended strategy.
- Specify who is to be responsible for implementing each program and how long each program will take to complete.
- Refer to the pro forma financial statements you developed earlier for your recommended strategy. Use common-size historical income statements as the basis for the pro forma statement. Do the numbers still make sense? If not, this may be a good time to rethink the budget numbers to reflect your recommended programs.

9. WRITE YOUR STRATEGIC AUDIT: PART VIII



Evaluation and Control

- Specify the type of evaluation and controls that you need to ensure that your recommendation is carried out successfully. Specify who is responsible for monitoring these controls.
- Indicate whether sufficient information is available to monitor how the strategy is being implemented. If not, suggest a change to the information system.

10. PROOF AND FINE-TUNE YOUR AUDIT

Final Draft of Your Strategic Audit

- Check to ensure that your audit is within the page limits of your professor. You may need to cut some parts and expand others.
- Make sure that your recommendation clearly deals with the strategic factors.
- **Attach your EFAS and IFAS Tables, and SFAS Matrix,** plus your ratio analysis and pro forma statements. Label them as numbered exhibits and refer to each of them within the body of the audit.
- Proof your work for errors. If on a computer, use a spell checker.

SPECIAL NOTE: Depending on your assignment, it is relatively easy to use the strategic audit you have just developed to write a written case analysis in essay form or to make an oral presentation. The strategic audit is just a detailed case analysis in an outline form and can be used as the basic framework for any sort of case analysis and presentation.

APPENDIX 12.C

Example of Student-Written Strategic Audit

(For the 1993 Maytag Corporation Case)

I. Current Situation

A. Current Performance

Poor financials, high debt load, first losses since 1920s, price/earnings ratio negative.

- First loss since 1920s.
- Laid off 4,500 employees at Magic Chef.
- Hoover Europe still showing losses.

B. Strategic Posture

1. **Mission**
   - Developed in 1989 for the Maytag Company: "To provide our customers with products of unsurpassed performance that last longer, need fewer repairs, and are produced at the lowest possible cost."
   - Updated in 1991: "Our collective mission is world class quality." Expands Maytag's belief in product quality to all aspects of operations.
2. **Objectives**
   - "To be profitability leader in industry for every product line Maytag manufactures." Selected profitability rather than market share.
   - "To be number one in total customer satisfaction." Doesn't say how to measure satisfaction.
   - "To grow the North American appliance business and become the third largest appliance manufacturer (in unit sales) in North America."
   - To increase profitable market share growth in North American appliance and floor care business, 6.5% return on sales, 10% return on assets, 20% return on equity, beat competition in satisfying customers, dealer, builder and endorser, move into third place in total units shipped per year. Nicely quantified objectives.
3. **Strategies**
   - Global growth through acquisition, and alliance with Bosch-Siemens.
   - Differentiate brand names for competitive advantage.
   - Create synergy between companies, product improvement, investment in plant and equipment.

4. **Policies**
   - Cost reduction is secondary to high quality.
   - Promotion from within.
   - Slow but sure R&D: Maytag slow to respond to changes in market.

II. Strategic Managers

A. Board of Directors

1. Fourteen members—eleven are outsiders.
2. Well-respected Americans, most on board since 1986 or earlier.
3. No international or marketing backgrounds.
4. Time for a change?

B. Top Management

1. Top management promoted from within Maytag Company. Too inbred?
2. Very experienced in the industry.
3. Responsible for current situation.
4. May be too parochial for global industry. May need new blood.

III. External Environment (EFAS Table; see Exhibit 1)

A. Natural Environment

1. Growing water scarcity
2. Energy availability a growing problem

B. Societal Environment

1. **Economic**
   a. Unstable economy but recession ending, consumer confidence growing—could increase spending for big ticket items like houses, cars, and appliances. **(O)**
   b. Individual economies becoming interconnected into a world economy. **(O)**
2. **Technological**
   a. Fuzzy logic technology being applied to sense and measure activities. **(O)**
   b. Computers and information technology increasingly important. **(O)**
3. **Political–Legal**
   a. NAFTA, European Union, other regional trade pacts opening doors to markets in Europe, Asia, and Latin America that offer enormous potential. **(O)**
   b. Breakdown of communism means less chance of world war. **(O)**
   c. Environmentalism being reflected in laws on pollution and energy usage. **(T)**
4. **Sociocultural**
   a. Developing nations desire goods seen on TV. **(O)**
   b. Middle-aged baby boomers want attractive, high-quality products, like BMWs and Maytag. **(O)**
   c. Dual-career couples increases need for labor-saving appliances, second cars, and day care. **(O)**
   d. Divorce and career mobility means need for more houses and goods to fill them. **(O)**

C. Task Environment

1. North American market mature and extremely competitive—vigilant consumers demand high quality with low price in safe, environmentally sound products. **(T)**
2. Industry going global as North American and European firms expand internationally. **(T)**
3. European design popular and consumer desire for technologically advanced appliances. **(O)**
4. **Rivalry High**. Whirlpool, Electrolux, GE have enormous resources & developing global presence. **(T)**
5. **Buyers' Power Low**. Technology and materials can be sourced worldwide. **(O)**
6. **Power of Other Stakeholders Medium**. Quality, safety, environmental regulations increasing. **(T)**
7. **Distributors' Power High**. Super retailers more important: mom and pop dealers less. **(T)**
8. **Threat of Substitutes Low**. **(O)**
9. **Entry Barriers High**. New entrants unlikely except for large international firms. **(T)**

IV. Internal Environment (IFAS Table; see Exhibit 2)

A. Corporate Structure

1. Divisional structure: appliance manufacturing and vending machines. Floor care managed separately. **(S)**
2. Centralized major decisions by Newton corporate staff, with a time line of about three years. **(S)**

B. Corporate Culture

1. Quality key ingredient—commitment to quality shared by executives and workers. **(S)**
2. Much of corporate culture is based on founder F. L. Maytag's personal philosophy, including concern for quality, employees, local community, innovation, and performance. **(S)**
3. Acquired companies, except for European, seem to accept dominance of Maytag culture. **(S)**

C. Corporate Resources

1. **Marketing**
   a. Maytag brand lonely repairman advertising successful but dated. **(W)**
   b. Efforts focus on distribution—combining three sales forces into two, concentrating on major retailers. (Cost $95 million for this restructuring.) **(S)**
   c. Hoover's well-publicized marketing fiasco involving airline tickets. **(W)**
2. **Finance** (see **Exhibits 4 and 5**)
   a. Revenues are up slightly, operating income is down significantly. **(W)**
   b. Some key ratios are troubling, such as a 57% debt/asset ratio, 132% long-term debt/equity ratio. No room for more debt to grow company. **(W)**
   c. Net income is 400% less than 1988, based on common-size income statements. **(W)**
3. **R&D**
   a. Process-oriented with focus on manufacturing process and durability. **(S)**
   b. Maytag becoming a technology follower, taking too long to get product innovations to market (competitors put out more in last 6 months than prior 2 years combined), lagging in fuzzy logic and other technological areas. **(W)**

4. **Operations**
   a. Maytag's core competence. Continual improvement process kept it dominant in the U.S. market for many years. **(S)**
   b. Plants aging and may be losing competitiveness as rivals upgrade facilities. Quality no longer distinctive competence? **(W)**
5. **Human Resources**
   a. Traditionally very good relations with unions and employees. **(S)**
   b. Labor relations increasingly strained, with two salary raise delays, and layoffs of 4,500 employees at Magic Chef. **(W)**
   c. Unions express concern at new, more distant tone from Maytag Corporation. **(W)**
6. **Information Systems**
   a. Not mentioned in case. Hoover fiasco in Europe suggests information systems need significant upgrading. **(W)**
   b. Critical area where Maytag may be unwilling or unable to commit resources needed to stay competitive. **(W)**

V. Analysis of Strategic Factors

A. Situational Analysis (SWOT) (SFAS Matrix; see Exhibit 3)

1. **Strengths**
   a. Quality Maytag culture.
   b. Maytag well-known and respected brand.
   c. Hoover's international orientation.
   d. Core competencies in process R&D and manufacturing.
2. **Weaknesses**
   a. Lacks financial resources of competitors.
   b. Poor global positioning. Hoover weak on European continent.
   c. Product R&D and customer service innovation areas of serious weakness.
   d. Dependent on small dealers.
   e. Marketing needs improvement.
3. **Opportunities**
   a. Economic integration of European Community.
   b. Demographics favor quality.
   c. Trend to superstores.
4. **Threats**
   a. Trend to superstores.
   b. Aggressive rivals—Whirlpool and Electrolux.
   c. Japanese appliance companies—new entrants?

B. Review of Current Mission and Objectives

1. Current mission appears appropriate.
2. Some of the objectives are really goals and need to be quantified and given time horizons.

VI. Strategic Alternatives and Recommended Strategy

A. Strategic Alternatives

1. *Growth through Concentric Diversification*: Acquire a company in a related industry such as commercial appliances.
   a. ***[Pros]:*** Product/market synergy created by acquisition of related company.
   b. ***[Cons]:*** Maytag does not have the financial resources to play this game.

2. *Pause Strategy*: Consolidate various acquisitions to find economies and to encourage innovation among the business units.
   a. ***[Pros]:*** Maytag needs to get its financial house in order and get administrative control over its recent acquisitions.
   b. ***[Cons]:*** Unless it can grow through a stronger alliance with Bosch-Siemens or some other backer, Maytag is a prime candidate for takeover because of its poor financial performance in recent years, and it is suffering from the initial reduction in efficiency inherent in acquisition strategy.
3. *Retrenchment*: Sell Hoover's foreign major home appliance businesses (Australia and UK) to emphasize increasing market share in North America.
   a. ***[Pros]:*** Divesting Hoover improves bottom line and enables Maytag Corp. to focus on North America while Whirlpool, Electrolux, and GE are battling elsewhere.
   b. ***[Cons]:*** Maytag may be giving up its only opportunity to become a player in the coming global appliance industry.

B. Recommended Strategy

1. Recommend pause strategy, at least for a year, so Maytag can get a grip on its European operation and consolidate its companies in a more synergistic way.
2. Maytag quality must be maintained, and continued shortage of operating capital will take its toll, so investment must be made in R&D.
3. Maytag may be able to make the Hoover UK investment work better since the recession is ending and the EU countries are closer to integrating than ever before.
4. Because it is only an average competitor, Maytag needs the Hoover link to Europe to provide a jumping off place for negotiations with Bosch-Siemens that could strengthen their alliance.

VII. Implementation

A. The only way to increase profitability in North America is to further involve Maytag with the superstore retailers; sure to anger the independent dealers, but necessary for Maytag to compete.

B. Board members with more global business experience should be recruited, with an eye toward the future, especially with expertise in Asia and Latin America.

C. R&D needs to be improved, as does marketing, to get new products online quickly.

VIII. Evaluation and Control

A. MIS needs to be developed for speedier evaluation and control. While the question of control vs. autonomy is "under review," another Hoover fiasco may be brewing.

B. The acquired companies do not all share the Midwestern work ethic or the Maytag Corporation culture, and Maytag's managers must inculcate these values into the employees of all acquired companies.

C. Systems should be developed to decide if the size and location of Maytag manufacturing plants is still correct and to plan for the future. Industry analysis indicates that smaller automated plants may be more efficient now than in the past.

EXHIBIT 1 EFAS Table for Maytag Corporation 1993

External Factors	Weight	Rating	Weighted Score	Comments
1	2	3	4	5
Opportunities				
■ Economic integration of European Community	.20	4.1	.82	Acquisition of Hoover
■ Demographics favor quality appliances	.10	5.0	.50	Maytag quality
■ Economic development of Asia	.05	1.0	.05	Low Maytag presence
■ Opening of Eastern Europe	.05	2.0	.10	Will take time
■ Trend to "Super Stores"	.10	1.8	.18	Maytag weak in this channel
Threats				
■ Increasing government regulations	.10	4.3	.43	Well positioned
■ Strong U.S. competition	.10	4.0	.40	Well positioned
■ Whirlpool and Electrolux strong globally	.15	3.0	.45	Hoover weak globally
■ New product advances	.05	1.2	.06	Questionable
■ Japanese appliance companies	.10	1.6	.16	Only Asian presence in Australia
Total Scores	1.00		3.15	

EXHIBIT 2 IFAS Table for Maytag Corporation 1993

Internal Factors	Weight	Rating	Weighted Score	Comments
1	2	3	4	5
Strengths				
■ Quality Maytag culture	.15	5.0	.75	Quality key to success
■ Experienced top management	.05	4.2	.21	Know appliances
■ Vertical integration	.10	3.9	.39	Dedicated factories
■ Employer relations	.05	3.0	.15	Good, but deteriorating
■ Hoover's international orientation	.15	2.8	.42	Hoover name in cleaners
Weaknesses				
■ Process-oriented R&D	.05	2.2	.11	Slow on new products
■ Distribution channels	.05	2.0	.10	Superstores replacing small dealers
■ Financial position	.15	2.0	.30	High debt load
■ Global positioning	.20	2.1	.42	Hoover weak outside the United Kingdom and Australia
■ Manufacturing facilities	.05	4.0	.20	Investing now
Total Scores	1.00		3.05	

EXHIBIT 5

Common Size Income Statements for Maytag Corporation 1993

	1992	1991	1990
Net Sales	100.0%	100.0%	100.0%
Cost of Sales	76.92	75.88	75.50
Gross Profit	23.08	24.12	24.46
Selling, general/admin. expenses	17.37	17.67	16.90
Reorganization Expenses	.031	——	——
Operating Income	.026	.064	.075
Interest Expense	(.025)	(.025)	(0.26)
Other-net	.001	.002	.009
Income before accounting changes	.002	.042	.052
Income taxes	.005	.015	.020
Income before accounting changes	(.002)	.026	.032
Effect of accounting changes for post-retirement benefits other than pensions and income taxes	(.101)	------	------
Total Operating Costs and Expenses	74.9	76.0	76.3
Net Income	**(.104)**	**.026**	**.032**

EXHIBIT 6 Implementation, Evaluation, & Control Plan for Maytag Corporation 1993

Strategic Factor	Action Plan	Priority System (1–5)	Who Will Implement	Who Will Review	How Often Review	Criteria Used
Quality Maytag culture	Build quality in acquired units	1	Heads of acquired units	Manufacturing VP	Quarterly	Number defects & customer satisfaction
Hoover's international orientation	Identify ways to expand sales	2	Head of Hoover	Marketing VP	Quarterly	Feasible alternatives generated
Financial position	Pay down debt	1	CFO	CEO	Monthly	Leverage ratios
Global positioning	Find strategic alliance partners	2	VP of Business Development	COO	Quarterly	Feasible alternatives generated
EU economic integration	Grow sales throughout EU	3	Hoover UK Head	Marketing VP	Annually	Sales growth
Demographics favor quality	Simplify controls	3	Manufacturing VP	COO	Annually	Market research user satisfaction
Trend to super stores	Market through Sears	1	Marketing VP	CEO	Monthly	Sales growth
Whirlpool & Electrolux	Monitor competitor performance	1	Competition committee	COO	Quarterly	Competitor sales & new products
Japanese appliance companies	Monitor expansion	4	Head of Hoover Australia	Competition committee	Semi-annually	Sales growth outside Japan

Ending Case for Part Five

IN THE GARDEN

Walking with my watering can underneath the cherry tree, the apricot tree, the plum tree, and the nectarine tree, strawberry vines and raspberry canes at my feet, I gazed at my hedge and thought what would it take to avoid disease in the garden this year? I was amazed how this garden, so similar and different from previous seasons, had evolved from two saplings, purchased by chance, placed by happenstance, but planted with care. Now I wondered at the wild order. Was this the fruit I should be growing? How could I end up with the sweetest fruit, and what about the most fruit and the largest fruit? How would I set myself up for more success next year, and what of the years after that? And, I sadly thought, what shall I do with the wonderful apple tree I climbed as a child that now yielded so little fruit?

All these thoughts I had walking with my watering can under the cherry tree, the apricot tree, the plum tree, and the nectarine tree, strawberry vines and raspberry canes at my feet.

.....

This case was written by Mark Meckler, University of Portland and presented to the North American Case Research Association at its 2006 annual meeting. Copyright © 2006 by Mark Meckler. Edited for publication in *Strategic Management and Business Policy*, 12th edition and *Concepts in Strategic Management and Business Policy*, 12th edition. Reprinted by permission of Mark Meckler and the North American Case Research Association.

EXHIBIT 3 SFAS Matrix for Maytag Corporation 1993

1 Strategic Factors (Select the most important opportunities/threats from EFAS, Table 4–5 and the most important strengths and weaknesses from IFAS, Table 5–2)	2 Weight	3 Rating	4 Weighted Score	Duration SHORT	Duration INTERMEDIATE	5 LONG	6 Comments
▸S1 Quality Maytag culture (S)	.10	5.0	.50			X	Quality key to success
▸S5 Hoover's international orientation (S)	.10	2.8	.28	X	X		Name recognition
▸W3 Financial position (W)	.10	2.0	.20	X	X		High debt
▸W4 Global positioning (W)	.15	2.2	.33		X	X	Only in N.A., U.K., and Australia
▸O1 Economic integration of European Community (O)	.10	4.1	.41			X	Acquisition of Hoover
▸O2 Demographics favor quality (O)	.10	5.0	.50		X		Maytag quality
▸O5 Trend to super stores (O + T)	.10	1.8	.18	X			Weak in this channel
▸T3 Whirlpool and Electrolux (T)	.15	3.0	.45	X			Dominate industry
▸T5 Japanese appliance companies (T)	.10	1.6	.16			X	Asian presence
Total Scores	1.00		3.01				

EXHIBIT 4 Ratio Analysis for Maytag Corporation 1993

	1990	1991	1992	1993
1. LIQUIDITY RATIOS				
Current	2.1	1.9	1.8	1.6
Quick	1.1	1.0	1.1	1.0
2. LEVERAGE RATIOS				
Debt to Total Assets	61%	60%	76%	57%
Debt to Equity	155%	151%	317%	254%
3. ACTIVITY RATIOS				
Inventory turnover—sales	5.7	6.1	7.6	6.9
Inventory Turnover—cost of sales	4.3	4.6	5.8	6.5
Avg. Collection Period—days	57	55	56	0
Fixed Asset Turnover	3.9	3.6	3.6	3.6
Total Assets Turnover	1.2	1.2	1.2	1.1
4. PROFITABILITY RATIOS				
Gross Profit Margin	24%	24%	23%	5%
Net Operating Margin	8%	6%	3%	5%
Profit Margin on Sales	3%	3%	−0%	2%
Return on Total Assets	4%	3%	−0%	2%
Return on Equity	10%	8%	−1%	8%

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Cases in

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cases in strategic management

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CASE 1

The Recalcitrant Director at Byte Products, Inc.:

CORPORATE LEGALITY VERSUS CORPORATE RESPONSIBILITY

Dan R. Dalton, Richard A. Cosier, and Cathy A. Enz

BYTE PRODUCTS, INC., IS PRIMARILY INVOLVED IN THE PRODUCTION OF ELECTRONIC components that are used in personal computers. Although such components might be found in a few computers in home use, Byte products are found most frequently in computers used for sophisticated business and engineering applications. Annual sales of these products have been steadily increasing over the past several years; Byte Products, Inc., currently has total sales of approximately $265 million.

Over the past six years, increases in yearly revenues have consistently reached 12%. Byte Products, Inc., headquartered in the midwestern United States, is regarded as one of the largest-volume suppliers of specialized components and is easily the industry leader, with some 32% market share. Unfortunately for Byte, many new firms—domestic and foreign—have entered the industry. A dramatic surge in demand, high profitability, and the relative ease of a new firm's entry into the industry explain in part the increased number of competing firms.

Although Byte management—and presumably shareholders as well—is very pleased about the growth of its markets, it faces a major problem: Byte simply cannot meet the demand for these components. The company currently operates three manufacturing facilities in various locations throughout the United States. Each of these plants operates three production shifts (24 hours per day), 7 days a week. This activity constitutes virtually all of the company's production capacity. Without an additional manufacturing plant, Byte simply cannot increase its output of components.

This case was prepared by Professors Dan R. Dalton and Richard A. Cosier of the Graduate School of Business at Indiana University and Cathy A. Enz of Cornell University. The names of the organization, individual, location, and/or financial information have been disguised to preserve the organization's desire for anonymity. This case was edited for SMBP–9th, 10th, 11th, 12th, and 13th Editions. Reprint permission is solely granted to the publisher, Prentice Hall, for the book, *Strategic Management and Business Policy – 13th Edition* by copyright holders Dan R. Dalton, Richard A. Cosier, and Cathy A. Enz. Any other publication of this case (translation, any form of electronic or other media), or sold (any form of partnership) to another publisher will be in violation of copyright laws, unless the copyright holders have granted an additional written reprint permission.

James M. Elliott, Chief Executive Officer and Chairman of the Board, recognizes the gravity of the problem. If Byte Products cannot continue to manufacture components in sufficient numbers to meet the demand, buyers will go elsewhere. Worse yet is the possibility that any continued lack of supply will encourage others to enter the market. As a long-term solution to this problem, the Board of Directors unanimously authorized the construction of a new, state-of-the-art manufacturing facility in the southwestern United States. When the planned capacity of this plant is added to that of the three current plants, Byte should be able to meet demand for many years to come. Unfortunately, an estimated three years will be required to complete the plant and bring it online.

Jim Elliott believes very strongly that this three-year period is far too long and has insisted that there also be a shorter-range, stopgap solution while the plant is under construction. The instability of the market and the pressure to maintain leader status are two factors contributing to Elliott's insistence on a more immediate solution. Without such a move, Byte management believes that it will lose market share and, again, attract competitors into the market.

Several Solutions

A number of suggestions for such a temporary measure were offered by various staff specialists but rejected by Elliott. For example, licensing Byte's product and process technology to other manufacturers in the short run to meet immediate demand was possible. This licensing authorization would be short term, or just until the new plant could come online. Top management, as well as the board, was uncomfortable with this solution for several reasons. They thought it unlikely that any manufacturer would shoulder the fixed costs of producing appropriate components for such a short term. Any manufacturer that would do so would charge a premium to recover its costs. This suggestion, obviously, would make Byte's own products available to its customers at an unacceptable price. Nor did passing any price increase to its customers seem sensible, for this too would almost certainly reduce Byte's market share as well as encourage further competition.

Overseas facilities and licensing also were considered but rejected. Before it became a publicly traded company, Byte's founders had decided that its manufacturing facilities would be domestic. Top management strongly felt that this strategy had served Byte well; moreover, Byte's majority stockholders (initial owners of the then privately held Byte) were not likely to endorse such a move. Beyond that, however, top management was reluctant to foreign license—or make available by any means the technologies for others to produce Byte products—as they could not then properly control patents. Top management feared that foreign licensing would essentially give away costly proprietary information regarding the company's highly efficient means of product development. There also was the potential for initial low product quality—whether produced domestically or otherwise—especially for such a short-run operation. Any reduction in quality, however brief, would threaten Byte's share of this sensitive market.

The Solution!

One recommendation that has come to the attention of the Chief Executive Officer could help solve Byte's problem in the short run. Certain members of his staff have notified him that an abandoned plant currently is available in Plainville, a small town in the northeastern United States. Before its closing eight years before, this plant was used primarily for the manufacture of electronic components. As is, it could not possibly be used to produce Byte products, but it could be inexpensively refitted to do so in as few as three months. Moreover, this plant is available at a very attractive price. In fact, discreet inquiries by Elliott's staff indicate that this plant could probably be leased immediately from its present owners because the building has been vacant for some eight years.

All the news about this temporary plant proposal, however, is not nearly so positive. Elliott's staff concedes that this plant will never be efficient and its profitability will be low. In addition, the Plainville location is a poor one in terms of high labor costs (the area is highly unionized), warehousing expenses, and inadequate transportation links to Byte's major markets and suppliers. Plainville is simply not a candidate for a long-term solution. Still, in the short run, a temporary plant could help meet the demand and might forestall additional competition.

The staff is persuasive and notes that this option has several advantages: (1) there is no need for any licensing, foreign or domestic, (2) quality control remains firmly in the company's hands, and (3) an increase in the product price will be unnecessary. The temporary plant, then, would be used for three years or so until the new plant could be built. Then the temporary plant would be immediately closed.

CEO Elliott is convinced.

Taking the Plan to the Board

The quarterly meeting of the Board of Directors is set to commence at 2:00 P.M. Jim Elliott has been reviewing his notes and agenda for the meeting most of the morning. The issue of the temporary plant is clearly the most important agenda item. Reviewing his detailed presentation of this matter, including the associated financial analyses, has occupied much of his time for several days. All the available information underscores his contention that the temporary plant in Plainville is the only responsible solution to the demand problems. No other option offers the same low level of risk and ensures Byte's status as industry leader.

At the meeting, after the board has dispensed with a number of routine matters, Jim Elliott turns his attention to the temporary plant. In short order, he advises the 11-member board (himself, 3 additional inside members, and 7 outside members) of his proposal to obtain and refit the existing plant to ameliorate demand problems in the short run, authorizes the construction of the new plant (the completion of which is estimated to take some three years), and plans to switch capacity from the temporary plant to the new one when it is operational. He also briefly reviews additional details concerning the costs involved, advantages of this proposal versus domestic or foreign licensing, and so on.

All the board members except one are in favor of the proposal. In fact, they are most enthusiastic; the overwhelming majority agree that the temporary plant is an excellent—even inspired—stopgap measure. Ten of the eleven board members seem relieved because the board was most reluctant to endorse any of the other alternatives that had been mentioned.

The single dissenter—T. Kevin Williams, an outside director—is, however, steadfast in his objections. He will not, under any circumstances, endorse the notion of the temporary plant and states rather strongly that "I will not be party to this nonsense, not now, not ever."

T. Kevin Williams, the senior executive of a major nonprofit organization, is normally a reserved and really quite agreeable person. This sudden, uncharacteristic burst of emotion clearly startles the remaining board members into silence. The following excerpt captures the ensuing, essentially one-on-one conversation between Williams and Elliott:

Williams: How many workers do your people estimate will be employed in the temporary plant?

Elliott: Roughly 1,200, possibly a few more.

Williams: I presume it would be fair, then, to say that, including spouses and children, something on the order of 4,000 people will be attracted to the community.

Elliott: I certainly would not be surprised.

Williams: If I understand the situation correctly, this plant closed just over eight years ago, and that closing had a catastrophic effect on Plainville. Isn't it true that a large portion of the community was employed by this plant?

Elliott: Yes, it was far and away the majority employer.

Williams: And most of these people have left the community, presumably to find employment elsewhere.

Elliott: Definitely, there was a drastic decrease in the area's population.

Williams: Are you concerned, then, that our company can attract the 1,200 employees to Plainville from other parts of New England?

Elliott: Not in the least. We are absolutely confident that we will attract 1,200—even more, for that matter virtually any number we need. That, in fact, is one of the chief advantages of this proposal. I would think that the community would be very pleased to have us there.

Williams: On the contrary, I would suspect that the community will rue the day we arrived. Beyond that, though, this plan is totally unworkable if we are candid. On the other hand, if we are less than candid, the proposal will work for us, but only at great cost to Plainville. In fact, quite frankly, the implications are appalling. Once again, I must enter my serious objections.

Elliott: I don't follow you.

Williams: The temporary plant would employ some 1,200 people. Again, this means the infusion of over 4,000 to the community and surrounding areas. Byte Products, however, intends to close this plant in three years or less. If Byte informs the community or the employees that the jobs are temporary, the proposal simply won't work. When the new people arrive in the community, there will be a need for more schools, instructors, utilities, housing, restaurants, and so forth. Obviously, if the banks and local government know that the plant is temporary, no funding will be made available for these projects and certainly no credit for the new employees to buy homes, appliances, automobiles, and so forth.

If, on the other hand, Byte Products does not tell the community of its "temporary" plans, the project can go on. But, in several years when the plant closes (and we here have agreed today that it will close), we will have created a ghost town. The tax base of the community will have been destroyed; property values will decrease precipitously; practically the whole town will be unemployed. This proposal will place Byte Products in an untenable position and in extreme jeopardy.

Elliott: Are you suggesting that this proposal jeopardizes us legally? If so, it should be noted that the legal department has reviewed this proposal in its entirety and has indicated no problem.

Williams: No! I don't think we are dealing with an issue of legality here. In fact, I don't doubt for a minute that this proposal is altogether legal. I do, however, resolutely believe that this proposal constitutes gross irresponsibility.

I think this decision has captured most of my major concerns. These along with a host of collateral problems associated with this project lead me to strongly suggest that you and the balance of the board reconsider and not endorse this proposal. Byte Products must find another way.

The Dilemma

After a short recess, the board meeting reconvened. Presumably because of some discussion during the recess, several other board members indicated that they were no longer inclined to support the proposal. After a short period of rather heated discussion, the following exchange took place:

Elliott: It appears to me that any vote on this matter is likely to be very close. Given the gravity of our demand capacity problem, I must insist that the stockholders' equity be protected. We cannot wait three years; that is clearly out of the question. I still feel that licensing—domestic or foreign—is not in our long-term interests for any number of reasons, some of which have been discussed here. On the other hand, I do not want to take this project forward on the strength of a mixed vote. A vote of 6–5 or 7–4, for example, does not indicate that the board is remotely close to being of one mind. Mr. Williams, is there a compromise to be reached?

Williams: Respectfully, I have to say no. If we tell the truth—namely, the temporary nature of our operations—the proposal is simply not viable. If we are less than candid in this respect, we do grave damage to the community as well as to our image. It seems to me that we can only go one way or the other. I don't see a middle ground.

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CASE 2

The Wallace Group

Laurence J. Stybel

FRANCES RAMPAR, PRESIDENT OF RAMPAR ASSOCIATES, DRUMMED HER FINGERS ON THE desk. Scattered before her were her notes. She had to put the pieces together in order to make an effective sales presentation to Harold Wallace.

Hal Wallace was the President of The Wallace Group. He had asked Rampar to conduct a series of interviews with some key Wallace Group employees, in preparation for a possible consulting assignment for Rampar Associates.

During the past three days, Rampar had been talking with some of these key people and had received background material about the company. The problem was not in finding the problem. The problem was that there were too many problems!

Background on The Wallace Group

The Wallace Group, Inc., is a diversified company dealing in the manufacture and development of technical products and systems (see **Exhibit 1**). The company currently consists of three operational groups and a corporate staff. The three groups include Electronics, Plastics, and Chemicals, each operating under the direction of a Group Vice President (see **Exhibits 2, 3,** and **4**). The company generates $70 million in sales as a manufacturer of plastics, chemical products, and electronic components and systems. Principal sales are to large contractors in governmental and automotive markets. With respect to sales volume, Plastics and Chemicals are approximately equal in size, and both of them together equal the size of the Electronics Group.

Electronics offers competence in the areas of microelectronics, electromagnetic sensors, antennas, microwaves, and minicomputers. Presently, these skills are devoted primarily to the engineering and manufacture of countermeasure equipment for aircraft. This includes radar detection systems that allow an aircraft crew to know that they are being tracked by radar units on the ground, on ships, or on other aircraft. Further, the company manufactures displays that provide the crew with a visual "fix" on where they are relative to the radar units that are tracking them.

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EXHIBIT 1
An Excerpt from the Annual Report

To the Shareholders:

This past year was one of definite accomplishment for The Wallace Group, although with some admitted soft spots. This is a period of consolidation, of strengthening our internal capacity for future growth and development. Presently, we are in the process of creating a strong management team to meet the challenges we will set for the future.

Despite our failure to achieve some objectives, we turned a profit of $3,521,000 before taxes, which was a growth over the previous year's earnings. And we have declared a dividend for the fifth consecutive year, albeit one that is less than the year before. However, the retention of earnings is imperative if we are to lay a firm foundation for future accomplishment.

Currently, The Wallace Group has achieved a level of stability. We have a firm foothold in our current markets, and we could elect to simply enact strong internal controls and maximize our profits. However, this would not be a growth strategy. Instead, we have chosen to adopt a more aggressive posture for the future, to reach out into new markets wherever possible and to institute the controls necessary to move forward in a planned and orderly fashion.

The Electronics Group performed well this past year and is engaged in two major programs under Defense Department contracts. These are developmental programs that provide us with the opportunity for ongoing sales upon testing of the final product. Both involve the creation of tactical display systems for aircraft being built by Lombard Aircraft for the Navy and the Air Force. Future potential sales from these efforts could amount to approximately $56 million over the next five years. Additionally, we are developing technical refinements to older, already installed systems under Army Department contracts.

In the future, we will continue to offer our technological competence in such tactical display systems and anticipate additional breakthroughs and success in meeting the demands of this market. However, we also believe that we have unique contributions to make to other markets, and to that end we are making the investments necessary to expand our opportunities.

Plastics also turned in a solid performance this past year and has continued to be a major supplier to Chrysler, Martin Tool, Foster Electric, and, of course, to our Electronics Group. The market for this group continues to expand, and we believe that additional investments in this group will allow us to seize a larger share of the future.

Chemicals' performance, admittedly, has not been as satisfactory as anticipated during the past year. However, we have been able to realize a small amount of profit from this operation and to halt what was a potentially dangerous decline in profits. We believe that this situation is only temporary and that infusions of capital for developing new technology, plus the streamlining of operations, has stabilized the situation. The next step will be to begin more aggressive marketing to capitalize on the group's basic strengths.

Overall, the outlook seems to be one of modest but profitable growth. The near term will be one of creating the technology and controls necessary for developing our market offerings and growing in a planned and purposeful manner. Our improvement efforts in the various company groups can be expected to take hold over the years with positive effect on results.

We wish to express our appreciation to all those who participated in our efforts this past year.

Harold Wallace
Chairman and President

In addition to manufacturing tested and proven systems developed in the past, The Wallace Group is currently involved in two major and two minor programs, all involving display systems. The Navy-A Program calls for the development of a display system for a tactical fighter plane; Air Force-B is another such system for an observation plane. Ongoing production orders are anticipated following flight testing. The other two minor programs, Army-LG and OBT-37, involve the incorporation of new technology into existing aircraft systems.

EXHIBIT 2
Organizational Chart: The Wallace Group (Electronics)

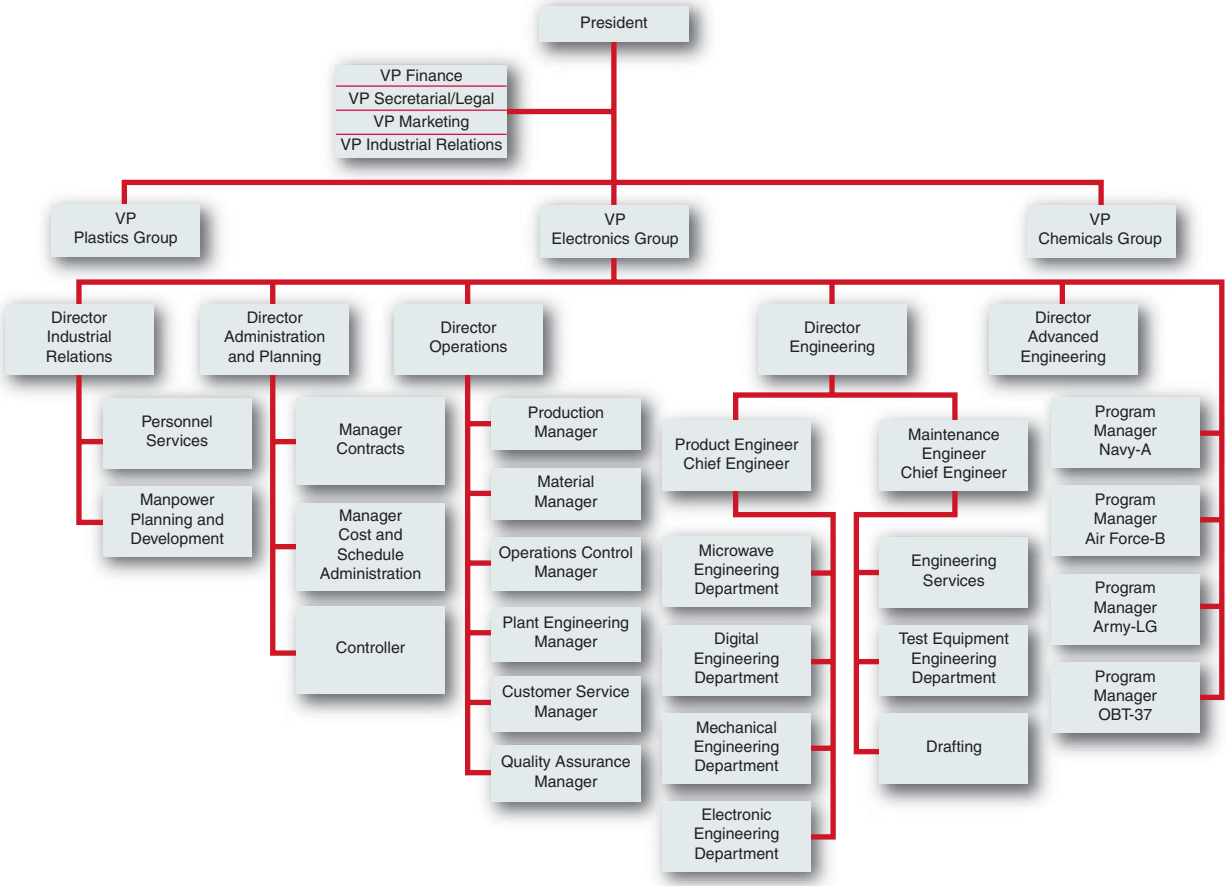


EXHIBIT 3
The Wallace Group
(Chemicals)

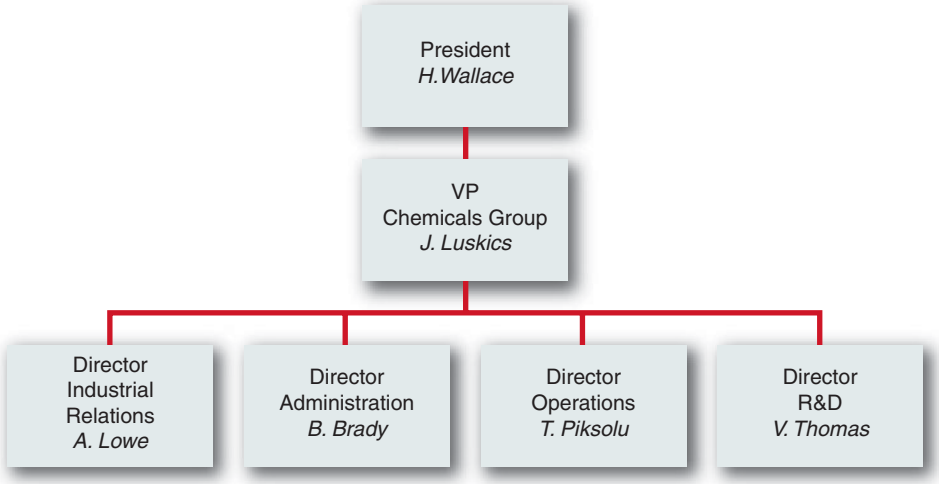
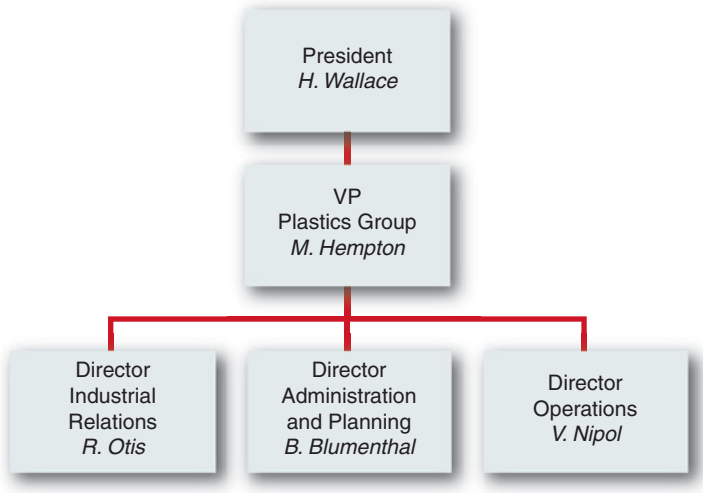


EXHIBIT 4
The Wallace Group
(Plastics)



The Plastics Group manufactures plastic components utilized by the electronics, automotive, and other industries requiring plastic products. These include switches, knobs, keys, insulation materials, and so on, used in the manufacture of electronic equipment and other small made-to-order components installed in automobiles, planes, and other products.

The Chemicals Group produces chemicals used in the development of plastics. It supplies bulk chemicals to the Plastics Group and other companies. These chemicals are then injected into molds or extruded to form a variety of finished products.

History of The Wallace Group

Each of the three groups began as a sole proprietorship under the direct operating control of an owner/manager. Several years ago, Harold Wallace, owner of the original electronics company, determined to undertake a program of diversification. Initially, he attempted to expand his market through product development and line extensions entirely within the electronics industry. However, because of initial problems, he drew back and sought other opportunities. Wallace's primary concern was his almost total dependence on defense-related contracts. He had felt for some time that he should take some strong action to gain a foothold in the private markets. The first major opportunity that seemed to satisfy his various requirements was the acquisition of a former supplier, a plastics company whose primary market was not defense-related. The company's owner desired to sell his operation and retire. At the time, Wallace's debt structure was such that he could not manage the acquisition and so he had to attract equity capital. He was able to gather a relatively small group of investors and form a closed corporation. The group established a Board of Directors with Wallace as Chairman and President of the new corporate entity.

With respect to operations, little changed. Wallace continued direct operational control over the Electronics Group. As holder of 60% of the stock, he maintained effective control over policy and operations. However, because of his personal interests, the Plastics Group, now under the direction of a newly hired Vice President, Martin Hempton, was left mainly to its own devices except for yearly progress reviews by the President. All Wallace asked at the time was that the Plastics Group continue its profitable operation, which it did.

Several years ago, Wallace and the board decided to diversify further because two-thirds of their business was still defense dependent. They learned that one of the major suppliers of the Plastics Group, a chemical company, was on the verge of bankruptcy. The company's

owner, Jerome Luskics, agreed to sell. However, this acquisition required a public stock offering, with most of the funds going to pay off debts incurred by the three groups, especially the Chemicals Group. The net result was that Wallace now holds 45% of The Wallace Group and Jerome Luskics 5%, with the remainder distributed among the public.

Organization and Personnel

Presently, Harold Wallace serves as Chairman and President of The Wallace Group. The Electronics Group had been run by LeRoy Tuscher, who just resigned as Vice President. Hempton continued as Vice President of Plastics, and Luskics served as Vice President of the Chemicals Group.

Reflecting the requirements of a corporate perspective and approach, a corporate staff has grown up, consisting of Vice Presidents for Finance, Secretarial/Legal, Marketing, and Industrial Relations. This staff has assumed many functions formerly associated with the group offices.

Because these positions are recent additions, many of the job accountabilities are still being defined. Problems have arisen over the responsibilities and relationships between corporate and group positions. President Wallace has settled most of the disputes himself because of the inability of the various parties to resolve differences among themselves.

Current Trends

Presently, there is a mood of lethargy and drift within The Wallace Group. Most managers feel that each of the three groups functions as an independent company. And, with respect to group performance, not much change or progress has been made in recent years. Electronics and Plastics are still stable and profitable, but both lack growth in markets and profits. The infusion of capital breathed new life and hope into the Chemicals operation but did not solve most of the old problems and failings that had caused its initial decline. For all these reasons, Wallace decided that strong action was necessary. His greatest disappointment was with the Electronics Group, in which he had placed high hopes for future development. Thus he acted by requesting and getting the Electronics Group Vice President's resignation. Hired from a computer company to replace LeRoy Tuscher, Jason Matthews joined The Wallace Group a week ago.

As of last week, Wallace's annual net sales were $70 million. By group they were:

Electronics	$35,000,000
Plastics	$20,000,000
Chemicals	$15,000,000

On a consolidated basis, the financial highlights of the past two years are as follows:

	Last Year	Two Years Ago
Net sales	$70,434,000	$69,950,000
Income (pre-tax)	3,521,000	3,497,500
Income (after-tax)	2,760,500	1,748,750
Working capital	16,200,000	16,088,500
Shareholders' equity	39,000,000	38,647,000
Total assets	59,869,000	59,457,000
Long-term debt	4,350,000	3,500,000
Per Share of Common Stock		
Net income	$.37	$.36
Cash dividends paid	.15	.25

Of the net income, approximately 70% came from Electronics, 25% from Plastics, and 5% from Chemicals.

The Problem Confronting Frances Rampar

As Rampar finished reviewing her notes (see **Exhibits 5–11**), she kept reflecting on what Hal Wallace had told her:

> Don't give me a laundry list of problems, Fran. Anyone can do that. I want a set of priorities I should focus on during the next year. I want a clear action plan from you. And I want to know how much this plan is going to cost me!

Fran Rampar again drummed her fingers on the desk.

EXHIBIT 5
Selected Portions of a Transcribed Interview with H. Wallace

Rampar: What is your greatest problem right now?

Wallace: That's why I called you in! Engineers are a high-strung, temperamental lot. Always complaining. It's hard to take them seriously.

Last month we had an annual stockholder's meeting. We have an Employee Stock Option Plan, and many of our long-term employees attended the meeting. One of my managers—and I won't mention any names—introduced a resolution calling for the resignation of the President—me!

The vote was defeated. But, of course, I own 45% of the stock!

Now I realize that there could be no serious attempt to get rid of me. Those who voted for the resolution were making a dramatic effort to show me how upset they are with the way things are going.

I could fire those employees who voted against me. I was surprised by how many did. Some of my key people were in that group. Perhaps I ought to stop and listen to what they are saying.

Businesswise, I think we're O.K. Not great, but O.K. Last year we turned in a profit of $3.5 million before taxes, which was a growth over previous years' earnings. We declared a dividend for the fifth consecutive year.

We're currently working on the creation of a tactical display system for aircraft being built by Lombard Aircraft for the Navy and the Air Force. If Lombard gets the contract to produce the prototype, future sales could amount to $56 million over the next five years.

Why are they complaining?

Rampar: You must have thoughts on the matter.

Wallace: I think the issue revolves around how we manage people. It's a personnel problem. You were highly recommended as someone with expertise in high-technology human resource management.

I have some ideas on what is the problem. But I'd like you to do an independent investigation and give me your findings. Give me a plan of action.

Don't give me a laundry list of problems, Fran. Anyone can do that. I want a set of priorities I should focus on during the next year. I want a clear action plan from you. And I want to know how much this plan is going to cost me!

Other than that, I'll leave you alone and let you talk to anyone in the company you want.

EXHIBIT 6
Selected Portions of a Transcribed Interview with Frank Campbell, Vice President of Industrial Relations

Rampar: What is your greatest problem right now?

Campbell: Trying to contain my enthusiasm over the fact that Wallace brought you in!

Morale is really poor here. Hal runs this place like a one man operation, when it's grown too big for that. It took a palace revolt to finally get him to see the depths of the resentment. Whether he'll do anything about it, that's another matter.

Rampar: What would you like to see changed?

Campbell: Other than a new President?

Rampar: Uh-huh.

Campbell: We badly need a management development program for our group. Because of our growth, we have been forced to promote technical people to management positions who have had no prior managerial experience. Mr. Tuscher agreed on the need for a program, but Hal Wallace vetoed the idea because developing such a program would be too expensive. I think it is too expensive *not* to move ahead on this.

Rampar: Anything else?

Campbell: The IEWU negotiations have been extremely tough this time around, due to excessive demands they have been making. Union pay scales are already pushing up against our foreman salary levels, and foremen are being paid high in their salary ranges. This problem, coupled with union insistence on a no-layoff clause, is causing us fits. How can we keep all our workers when we have production equipment on order that will eliminate 20% of our assembly positions?

Rampar: Wow.

Campbell: We have been sued by a rejected candidate for a position on the basis of discrimination. She claimed our entrance qualifications are excessive because we require shorthand. There is some basis for this statement since most reports are given to secretaries in handwritten form or on audio cassettes. In fact, we have always required it and our executives want their secretaries to have skill in taking dictation. Not only is this case taking time, but I need to reconsider if any of our position entrance requirements, in fact, are excessive. I am sure we do not want another case like this one.

Rampar: That puts The Wallace Group in a vulnerable position, considering the amount of government work you do.

Campbell: We have a tremendous recruiting backlog, especially for engineering positions. Either our pay scales are too low, our job specs are too high, or we are using the wrong recruiting channels. Kane and Smith [Director of Engineering and Director of Advanced Systems] keep rejecting everyone we send down there as being unqualified.

Rampar: Gee.

Campbell: Being head of human resources around here is a tough job. We don't act. We react.

EXHIBIT 7
Selected Portions of a Transcribed Interview with Matthew Smith, Director of Advanced Systems

Rampar: What is your greatest problem right now?

Smith: Corporate brass keeps making demands on me and others that don't relate to the job we are trying to get done. They say that the information they need is to satisfy corporate planning and operations review requirements, but they don't seem to recognize how much time and effort is required to provide this information. Sometimes it seems like they are generating analyses, reports, and requests for data just to keep themselves busy. Someone should be evaluating how critical these corporate staff activities really are. To me and the Electronics Group, these activities are unnecessary.

An example is the Vice President, Marketing (L. Holt), who keeps asking us for supporting data so he can prepare a corporate marketing strategy. As you know, we prepare our own group marketing strategic plans annually, but using data and formats that are oriented to our needs, rather than Corporate's. This planning activity, which occurs at the same time as Corporate's, coupled with heavy work loads on current projects, makes us appear to Holt as though we are being unresponsive.

Somehow we need to integrate our marketing planning efforts between our group and Corporate. This is especially true if our group is to successfully grow in nondefense-oriented markets and products. We do need corporate help, but not arbitrary demands for information that divert us from putting together effective marketing strategies for our group.

I am getting too old to keep fighting these battles.

Rampar: This is a long-standing problem?

Smith: You bet! Our problems are fairly classic in the high-tech field. I've been at other companies and they're not much better. We spend so much time firefighting, we never really get organized. Everything is done on an ad hoc basis.

I'm still waiting for tomorrow.

EXHIBIT 8
Selected Portions of a Transcribed Interview with Ralph Kane, Director of Engineering

Rampar: What is your greatest problem right now?

Kane: Knowing you were coming, I wrote them down. They fall into four areas:

1. Our salary schedules are too low to attract good, experienced EEs. We have been told by our Vice President (Frank Campbell) that corporate policy is to hire new people below the salary grade midpoint. All qualified candidates are making more than that now and in some case are making more than our grade maximums. I think our Project Engineer job is rated too low.
2. Chemicals Group asked for and the former Electronics Vice President (Tuscher) agreed to "lend" six of our best EEs to help solve problems it is having developing a new battery. That is great for the Chemicals Group, but meanwhile how do we solve the engineering problems that have cropped up in our Navy-A and OBT-37 programs?
3. As you know, Matt Smith (Director of Advanced Systems) is retiring in six months. I depend heavily on his group for technical expertise, and in some areas he depends heavily on some of my key engineers. I have lost some people to the Chemicals Group, and Matt has been trying to lend me some of his people to fill in. But he and his staff have been heavily involved in marketing planning and trying to identify or recruit a qualified successor long enough before his retirement to be able to train him or her. The result is that his people are up to their eyeballs in doing their own stuff and cannot continue to help me meet my needs.
4. IR has been preoccupied with union negotiations in the plant and has not had time to help me deal with this issue of management planning. Campbell is working on some kind of system that will help deal with this kind of problem and prevent them in the future. That is great, but I need help now—not when his "system" is ready.

EXHIBIT 9
Selected Portions of a Transcribed Interview with Brad Lowell, Program Manager, Navy-A

Rampar: What is your . . . ?

Lowell: . . . great problem? I'll tell you what it is. I still cannot get the support I need from Kane in Engineering. He commits and then doesn't deliver, and it has me quite concerned. The excuse now is that in "his judgment," Sid Wright needs the help for the Air Force program more than I do. Wright's program is one week ahead of schedule, so I disagree with "his judgment." Kane keeps complaining about not having enough people.

Rampar: Why do you think Kane says he doesn't have enough people?

Lowell: Because Hal Wallace is a tight-fisted S.O.B. who won't let us hire the people we need!

EXHIBIT 10
Selected Portions of a Transcribed Interview with Phil Jones, Director of Administration and Planning

Rampar: What is your greatest problem right now?

Jones: Wheel spinning—that's our problem! We talk about expansion, but we don't do anything about it. Are we serious or not?

For example, a bid request came in from a prime contractor seeking help in developing a countermeasure system for a medium-range aircraft. They needed an immediate response and concept proposal in one week. Tuscher just sat on my urgent memo to him asking for a go/no go decision on bidding. I could not give the contractor an answer (because no decision came from Tuscher), so they gave up on us.

I am frustrated because (1) we lost an opportunity we were "naturals" to win, and (2) my personal reputation was damaged because I was unable to answer the bid request. Okay, Tuscher's gone now, but we need to develop some mechanism so an answer to such a request can be made quickly.

Another thing, our MIS is being developed by the Corporate Finance Group. More wheel spinning! They are telling us what information we need rather than asking us what we want! E. Kay (our Group Controller) is going crazy trying to sort out the input requirements they need for the system and understanding the complicated reports that came out. Maybe this new system is great as a technical achievement, but what good is it to us if we can't use it?

EXHIBIT 11
Selected Portions of a Transcribed Interview with Burt Williams, Director of Operations

Rampar: What is your biggest problem right now?

Williams: One of the biggest problems we face right now stems from corporate policy regarding transfer pricing. I realize we are "encouraged" to purchase our plastics and chemicals from our sister Wallace groups, but we are also committed to making a profit! Because manufacturing problems in those groups have forced them to raise their prices, should *we* suffer the consequences? We can get some materials cheaper from other suppliers. How can we meet our volume and profit targets when we are saddled with noncompetitive material costs?

Rampar: And if that issue was settled to your satisfaction, then would things be O.K.?

Williams: Although out of my direct function, it occurs to me that we are not planning effectively our efforts to expand into nondefense areas. With minimal alteration to existing production methods, we can develop both end-use products (e.g., small motors, traffic control devices, and microwave transceivers for highway emergency communications) and components (e.g., LED and LCD displays, police radar tracking devices, and word processing system memory and control devices) with large potential markets.

The problems in this regard are:

1. Matt Smith (Director, Advanced Systems) is retiring and has had only defense-related experience. Therefore, he is not leading any product development efforts along these lines.
2. We have no marketing function at the group level to develop a strategy, define markets, and research and develop product opportunities.
3. Even if we had a marketing plan and products for industrial/commercial application, we have no sales force or rep network to sell the stuff.

   Maybe I am way off base, but it seems to me we need a Groups/Marketing/Sales function to lead us in this business expansion effort. It should be headed by an experienced technical marketing manager with a proven track record in developing such products and markets.

Rampar: Have you discussed your concerns with others?

Williams: I have brought these ideas up with Mr. Matthews and others at the Group Management Committee. No one else seems interested in pursuing this concept, but they won't say this outright and don't say why it should not be addressed. I guess that in raising the idea with you I am trying to relieve some of my frustrations.

CASE 3

Everyone Does It

Steven M. Cox and Shawana P. Johnson

JIM WILLIS WAS THE VICE PRESIDENT OF MARKETING AND SALES FOR INTERNATIONAL Satellite Images (ISI). ISI had been building a satellite to image the world at a resolution of one meter. At that resolution, a trained photo interpreter could identify virtually any military and civilian vehicle as well as numerous other military and non-military objects. The ISI team had been preparing a proposal for a Japanese government contractor. The contract called for a commitment of a minimum imagery purchase of $10 million per year for five years. In a recent executive staff meeting it became clear that the ISI satellite camera subcontractor was having trouble with the development of a thermal stabilizer for the instrument. It appeared that the development delay would be at least one year and possibly 18 months.

When Jim approached Fred Ballard, the President of ISI, for advice on what launch date to put into the proposal, Fred told Jim to use the published date because that was still the official launch date. When Jim protested that the use of an incorrect date was clearly unethical, Fred said, "Look Jim, no satellite has ever been launched on time. Everyone, including our competitors, publishes very aggressive launch dates. Customers understand the tentative nature of launch schedules. In fact, it is so common that customers factor into their plans the likelihood that spacecraft will not be launched on time. If we provided realistic dates, our launch dates would be so much later than those published by our competitors that we would never be able to sell any advanced contracts. So do not worry about it, just use the published date and we will revise it in a few months." Fred's words were not very comforting to Jim. It was true that satellite launch dates were seldom met, but putting a launch date into a proposal that ISI knew was no longer possible seemed underhanded. He wondered about the ethics of such a practice and the effect on his own reputation.

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The Industry

Companies from four nations, the United States, France, Russia, and Israel, controlled the satellite imaging industry. The U.S. companies had a clear advantage in technology and imagery clarity. In the United States, three companies dominated: Lockart, Global Sciences, and ISI. Each of these companies had received a license from the U.S. government to build and launch a satellite able to identify objects as small as one square meter. However, none had yet been able to successfully launch a commercial satellite with such a fine resolution. Currently, all of the companies had announced a launch date within six months of the ISI published launch date. Further, each company had to revise its launch date at least once, and in the case of Global Sciences, twice. Each time a company had revised its launch date, ongoing international contract negotiations with that company had been either stalled or terminated.

Financing a Satellite Program

The construction and ongoing operations of each of the programs was financed by venture capitalists. The venture capitalists relied heavily on advance contract acquisition to ensure the success of their investment. As a result, if any company was unable to acquire sufficient advance contracts, or if one company appeared to be gaining a lead on the others, there was a real possibility that the financiers would pull the plug on the other projects and the losing companies would be forced to stop production and possibly declare bankruptcy. The typical advance contract target was 150% of the cost of building and launching a satellite. Since the cost to build and launch was $200 million, each company was striving to acquire $300 million in advance contracts.

Advance contracts were typically written like franchise licensing agreements. Each franchisee guaranteed to purchase a minimum amount of imagery per year for five years, the engineered life of the satellite. In addition, each franchisee agreed to acquire the capability to receive, process, and archive the images sent to them from the satellite. Typically, the hardware and software cost was between $10 million and $15 million per installation. Because the data from each satellite was different, much of the software could not be used for multiple programs. In exchange, the franchisee was granted an exclusive reception and selling territory. The amount of each contract was dependent on the anticipated size of the market, the number of possible competitors in the market, and the readiness of the local military and civilian agencies to use the imagery. Thus, a contract in Africa would sell for as little as $1 million per year, whereas in several European countries $5–$10 million was not unreasonable. The problem was complicated by the fact that in each market there were usually only one or two companies with the financial strength and market penetration to become a successful franchisee. Therefore, each of the U.S. companies had targeted these companies as their prime prospects.

The Current Problem

Japan was expected to be the third largest market for satellite imagery after the United States and Europe. Imagery sales in Japan were estimated to be from $20 million to $30 million per year. Although the principal user would be the Japanese government, for political reasons the government had made it clear that they would be purchasing data through a local Japanese company. One Japanese company, Higashi Trading Company (HTC), had provided most of the imagery for civilian and military use to the Japanese government.

ISI had been negotiating with HTC for the past six months. It was no secret that HTC had also been meeting with representatives from Lockart and Global Sciences. HTC had sent

several engineers to ISI to evaluate the satellite and its construction progress. Jim Willis believed that ISI was currently the front-runner in the quest to sign HTC to a $10 million annual contract. Over five years, that one contract would represent one sixth of the contracts necessary to ensure sufficient venture capital to complete the satellite.

Jim was concerned that if a new launch date was announced, HTC would delay signing a contract. Jim was equally concerned that if HTC learned that Jim and his team knew of the camera design problems and knowingly withheld announcement of a new launch date until after completing negotiations, not only his personal reputation but that of ISI would be damaged. Furthermore, as with any franchise arrangement, mutual trust was critical to the success of each party. Jim was worried that even if only a 12-month delay in launch occurred, trust would be broken between ISI and the Japanese.

Jim's boss, Fred Ballard, had specifically told Jim that launch date information was company proprietary and that Jim was to use the existing published date when talking with clients. Fred feared that if HTC became aware of the delay, they would begin negotiating with one of ISI's competitors, who in Fred's opinion were not likely to meet their launch dates either. This change in negotiation focus by the Japanese would then have ramifications with the venture capitalists whom Fred had assured that a contract with the Japanese would soon be signed.

Jim knew that with the presentation date rapidly approaching, it was time to make a decision.

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CASE 4

The Audit

Gamewell D. Gantt, George A. Johnson, and John A. Kilpatrick

SUE WAS PUZZLED AS TO WHAT COURSE OF ACTION TO TAKE. SHE HAD RECENTLY STARTED her job with a national CPA firm, and she was already confronted with a problem that could affect her future with the firm. On an audit, she encountered a client who had been treating payments to a large number, but by no means a majority, of its workers as payments to independent contractors. This practice saves the client the payroll taxes that would otherwise be due on the payments if the workers were classified as employees. In Sue's judgment this was improper as well as illegal and should have been noted in the audit. She raised the issue with John, the senior accountant to whom she reported. He thought it was a possible problem but did not seem willing to do anything about it. He encouraged her to talk to the partner in charge if she didn't feel satisfied.

She thought about the problem for a considerable time before approaching the partner in charge. The ongoing professional education classes she had received from her employer emphasized the ethical responsibilities that she had as a CPA and the fact that her firm endorsed adherence to high ethical standards. This finally swayed her to pursue the issue with the partner in charge of the audit. The visit was most unsatisfactory. Paul, the partner, virtually confirmed her initial reaction that the practice was wrong, but he said that many other companies in the industry follow such a practice. He went on to say that if an issue was made of it, Sue would lose the account, and he was not about to take such action. She came away from the meeting with the distinct feeling that had she chosen to pursue the issue, she would have created an enemy.

Sue still felt disturbed and decided to discuss the problem with some of her co-workers. She approached Bill and Mike, both of whom had been working for the firm for a couple of years. They were familiar with the problem because they had encountered the same issue when doing the audit the previous year. They expressed considerable concern that if she went over the head of the partner in charge of the audit, they could be in big trouble since they had failed to question the practice during the previous audit. They said that they realized it was probably wrong, but they went ahead because it had been ignored in previous years, and they knew their supervisor wanted them to ignore it again this year. They didn't want to cause problems. They encouraged Sue to be a "team player" and drop the issue.

This case was prepared by Professors John A. Kilpatrick, Gamewell D. Gantt, and George A. Johnson of the College of Business, Idaho State University. The names of the organization, individual, location, and/or financial information have been disguised to preserve the organization's desire for anonymity. This case was edited for *SMBP*-9th, 10th, 11th, 12th, and 13th Editions. Presented to and accepted by the refereed Society for Case Research. All rights reserved to the authors and the SCR. Copyright © 1995 by John A. Kilpatrick, Gamewell D. Gantt, and George A. Johnson. This case may not be reproduced without written permission of the copyright holders. Reprinted by permission.

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CASE 5

Starbucks Coffee Company:

THE INDIAN DILEMMA

Ruchi Mankad and Joel Sarosh Thadamalla

As the world's second most populous country, with more than 1 billion people and growing at 6% per year, we see unique and great opportunity for bringing the Starbucks experience to this market (India).[1]
HOWARD SCHULTZ, CHAIRMAN, STARBUCKS CORPORATION

India is an important long-term growth opportunity in the Asia Pacific region. We're looking at our own strategy . . . We believe there is a growing affinity for global brands.[2]
MARTIN COLES, PRESIDENT, STARBUCKS COFFEE INTERNATIONAL

IN 2006, STARBUCKS COFFEE COMPANY (STARBUCKS), the world's No.1 specialty coffee retailer had over 11,000 stores in 36 countries of the world and employed over 10,000 people (see **Exhibit 1**). Every week over 40 million customers visited Starbucks coffeehouses. The company had over 7,600 retail locations in the United States, which was its home country and its biggest market. After phenomenal success in the United States, Starbucks entered one country after another and popularized its specialty coffee worldwide.

During the 1990s, Starbucks concentrated its expansion efforts mainly in Asia. In 1995 it entered Japan and by late 1990s Japan had became the second-most-profitable market for Starbucks. In 1999, Starbucks entered China and by 2006 Starbucks had become the leader in specialty coffee in China and had moved China up to the No. 1 priority.[3]

After Japan and China, Starbucks expressed its intentions to enter India. In 2002, Starbucks announced for the first time that it was planning to enter India.[4] Later it postponed its entry as it had entered China recently and was facing problems in Japan. In 2003, there was news again that Starbucks was reviving its plans to enter India. In 2004, Starbucks

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EXHIBIT 1
Starbucks Timeline

1971: The first Starbucks, under partners Gordon Bowker, Jerry Baldwin, and Zez Siegel, is opened across from Pike Place Market in Seattle, Washington.
1972: A second Starbucks store is opened in Seattle.
Early 1980s: Zev Siegel leaves the company. Jerry Baldwin takes over management of the company and functions as CEO. Gordon Bowker remains involved as a co-owner but other projects take up most of his time.
1982: Howard Schultz joins the company, taking charge of marketing and overseeing the retail stores.
1984: Starbucks acquires the five stores in San Francisco's Peet's Coffee and Tea chain.
April 1984: Starbucks opens its fifth store, the first one in downtown Seattle. Schultz convinces the owners to test an espresso bar, making this Starbucks the first to sell coffee beverages. It becomes a huge success.
Late 1984: The Starbucks founders are still resistant to installing espresso bars into other Starbucks locations and Schultz becomes increasingly frustrated. He has visited the espresso bars of Milan, Italy, and has a vision of bringing Italian-style espresso bars to America.
Late 1985: Schultz leaves Starbucks and starts the Il Giornale Coffee Company.
April 1986: The first Il Giornale store opens.
March 1987: Baldwin and Bowker decide to sell the Starbucks Coffee Company.
Aug. 1987: Schultz acquires Starbucks and rebrands all of his Il Giornale coffee houses with Starbucks name.
1992: Starbucks goes public with its initial public stock offering. At this time it has 165 outlets.
1996: The first Starbucks opens outside of North America in Tokyo, Japan.
Sept. 1997: Starbucks Chairman Howard Schultz publishes a book called *Pour Your Heart Into It: How Starbucks Built a Company One Cup at a Time*.
1999: Starbucks enters Hong Kong and China.
April 2003: Starbucks purchases Seattle's Best Coffee and Torrefazione Italia from AFC Enterprises and turns them all into Starbucks outlets. By this time, Starbucks has more than 6,400 outlets worldwide.
Oct. 4, 2004: XM Satellite Radio and Starbucks Coffee Company announce the debut of the Starbucks "Hear Music" channel on XM Radio. The station will feature 24-hour music programming featuring an "ever-changing mix of the best new music and essential recordings from all kinds of genres."
Sept. 8, 2005: Starbucks announces plans to donate funds and supplies to the Hurricane Katrina relief effort, worth monetary donations over $5 million as well as donations of coffee, water, and tea products.
Late 2005: Starbucks and Jim Beam Brands Co., a unit of Fortune Brands Inc., introduce a coffee liqueur product in the United States and announces plans to launch the product in 2006 in restaurants, bars, and retail outlets where premium distilled spirits are sold. The product will not be sold in company-operated or licensed stores.

SOURCE: *Compiled from www.starbucks.com.*

officials visited India but according to sources they returned unconvinced as they could not crystallize on an appropriate partner for its entry. In mid 2006, a Starbucks spokesperson said, "We are excited about the great opportunities that India presents to the company. We are looking forward to offering the finest coffee in the world, handcrafted beverages, the unique Starbucks experience (see **Exhibit 2**) to customers in this country within the next 18 months."[5]

EXHIBIT 2
The Starbucks Experience

Howard Schultz believed that Starbucks did not sell just a cup of coffee but provided a Starbucks experience, which he defined as, "You get more than the finest coffee when you visit a Starbucks—you get great people, first-rate music, a comfortable and upbeat meeting place, and sound advice on brewing excellent coffee at home. We establish the value of buying a product at Starbucks by our uncompromising quality and by building a personal relationship with each of our customers. Starbucks is rekindling America's love affair with coffee, bring romance and fresh flavor back to the brew.[6]

Starbucks' outlets provided a captivating atmosphere. Its stores were distinctive, sleek, and comfortable. Though the sizes of the stores and their formats varied, most were modeled after the Italian coffee bars where regulars sat and drank espresso with their friends. Starbucks stores tend to be located in high-traffic locations such as malls, busy street corners, and even grocery stores. They were well lighted and featured plenty of light cherry wood and artwork. The people who prepared the coffee are referred to as "baristas." Jazz or opera music played softly in the background. The stores ranged from 200 to 4,000 square feet, with new units tending to range from 1,500 to 1,700 square feet.

SOURCE: *Compiled by IBS Ahmedabad Research Center.*

About Starbucks

The Initial Years

In 1971, three partners, Gordon Bowker, Jerry Baldwin, and Zev Siegel opened a store in Seattle to roast and sell quality whole coffee beans. The trio had a passion for dark-roasted coffee, which was popular in Europe but yet to catch on in the United States. They chose Starbucks Coffee, Tea and Spice as the name of their store. The name Starbucks was taken from the name of a character from the novel Moby Dick. They chose the logo of a mermaid encircled by the store's name. The store offered a selection of 30 different varieties of whole-bean coffee, bulk tea, spices and other supplies but did not sell coffee by the cup. The popularity of the store grew and within 10 years, it employed 85 people, had five retail stores which sold freshly roasted coffee beans, a small roasting facility, and a wholesale business that supplied coffee to local restaurants. Its logo had become one of the most visible and respected logos.

Howard Schultz and Starbucks

Howard Schultz, who was later to lead Starbucks, was born in 1953. He started his career as a sales trainee at Xerox.[7] After three years at Xerox, the 26-year-old Schultz joined a Swedish housewares company, Hammerplast, which sold coffee makers to various retailers and Starbucks was one of its major customers. In 1981, Schultz visited Starbucks while on a business trip to Seattle. After visiting the company and its owners, he was completely fascinated. He realized that the specialty coffee business was close to his heart and he decided to be a part of Starbucks. In 1982 Schultz joined Starbucks as director, Retail Operations & Marketing.

In 1983, while on a company trip to Milan, Italy, Schultz observed the immense popularity of coffee, which was central to the national culture. In 1983, there were around 200,000 coffee bars in Italy and 1,500 coffee bars in Milan alone. The espresso[8] bars in the cities had trained baristas[9] who used high-quality Arabica beans to prepare espresso, cappuccino, and other drinks. Schultz witnessed that though each coffee bar had its own individual character, all provided a sense of comfort and the ambience of an extended family. During his week-long

stay in Milan, he made frequent visits to espresso bars. These visits were a revelation to Schultz, which he described in his book[10] thus:

> *As I watched, I had a revelation: Starbucks had missed the point, completely missed it… The connection to the people who loved coffee did not have to take place only in their homes, where they ground and brewed whole-bean coffee. What we had to do was unlock the romance and mystery of coffee, firsthand, in coffee bars. The Italians understood the personal relationship that people could have to coffee, its social aspect. Starbucks sold great coffee beans, but we didn't serve coffee by the cup. We treated coffee as produce, something to be bagged and sent home with the groceries. We stayed one big step away from the heart and soul of what coffee has meant throughout the centuries.*[11]

Schultz was convinced that he could recreate the Italian coffee culture in the United States through Starbucks and differentiate it from other specialty coffee suppliers. After returning, he tried to convince the owners to build Starbucks into a chain of Italian style espresso bars, but they refused. In 1985, Schultz left Starbucks and launched his own coffee bar; Il Giornale[12] coffee bar chain. The first Il Giornale store was opened in mid-1986 in a well-known office building in Seattle. The décor of the store resembled an Italian style coffee bar. The baristas wore white shirts and bow ties. All service was stand-up and no seating was provided. National and international newspapers were hung on stands. Only Italian opera was played. The store offered high-quality coffee in whole beans and in espresso drinks, such as cappuccino and caffe lattes.[13] It also offered salads and sandwiches. The menu was covered with Italian words. With the passage of time, many changes were done in the store décor based on feedback from customers. Chairs were added for those customers who wanted to stay longer in the store. Carryout business constituted a large part of the revenues, so paper cups for serving carryout customers were introduced. The store gained popularity and within six months the store was serving more than 1,000 customers a day. A second store opened in Seattle, six months after the first store. For the third store, Giornale went international and opened a store in Vancouver, British Columbia, in mid-1987. By this time, the sales in each store had reached around $500,000 a year.[14]

The New Starbucks

In early 1987 the founders of Starbucks decided to sell the assets of Starbucks, including its name. As soon as Schultz came to know about the decision, he decided to buy Starbucks. In August 1987, Schultz with the help of investors bought Starbucks, including its name, for $3.8 million.[15] All the stores were consolidated under the name Starbucks. Schultz promised the investors that Starbucks would open 125 stores in the next five years.

Starbucks first always gained a foothold in the market it entered and then moved on to the next market. Starbucks entered Chicago in 1987. Chicago proved a difficult market and presented several challenges to the company, initially. It took around three years for Starbucks to become successful in Chicago and by 1990 it was able to build a critical mass of loyal customers. Starbucks entered Los Angles in 1991 and achieved success without much struggle. As in other markets, Starbucks did not advertise its locations heavily but relied on the word-of-mouth promotions by the consumers.

Between 1990 and 1992 sales at Starbucks increased almost 300% and reached $103 million. Earnings reached to $4.4 million in 1992. Starbucks came out with an IPO[16] in 1992, which was very successful and raised $29 million for the company.

In 1993, Starbucks opened its first store in Washington, D.C. After succeeding in Washington, Starbucks opened stores in New York and Boston in 1994. Starbucks opened stores at places that were home to many opinion makers. Within a short duration, Starbucks was rated

as the best coffee in New York. In Boston after opening a few company-owned stores, Starbucks acquired the leading competitor, The Coffee Connection. The Coffee Connection was founded in 1975 and had around 24 stores in Boston in 1994. It specialized in light-roasted gourmet coffee and had a loyal customer base in Boston. After the acquisition, Starbucks became the leading player in Boston overnight.

Hot drinks at Starbucks were available in four cup sizes: Venti containing 20 oz.,[17] Grande containing 16 oz., Tall containing 12 oz., and Short containing 8 oz. Cold drinks were available in three cup sizes; Iced Venti–24 oz., Iced Grande–16 oz., and Iced Tall–12 oz.[18] In 1994, Starbucks launched Frappuccino, a cold drink made from coffee, sugar, low-fat milk, and ice. It became an instant hit and drew many non–coffee drinkers also to the store. In 1995, more than three million people visited Starbucks stores each week.[19]

Over time and with experience, Starbucks developed a sophisticated store-development process based on a six-month opening schedule. The process enabled it to open a store every day. In 1996 alone, Starbucks opened 330 outlets. It also refined its expansion strategy. Schultz said, "For each region we targeted a large city to serve as a hub where we located teams of professionals to support new stores. We entered large markets quickly, with the goal of opening 20 or more stores in the first two years. Then from that core we branched out, entering nearby spoke markets, including smaller cities and suburban locations with demographics similar to our typical customer mix."[20]

Starbucks was opposed to the concept of franchising. Schultz believed that, "If we had franchised, Starbucks would have lost the common culture that made us strong. We teach baristas not only how to handle the coffee properly but also how to impart to customers our passions for our products. They understand the vision and value system of the company, which is seldom the case when someone else's employees are serving Starbucks coffee."[21]

Starbucks initially believed in selling coffee only through its own outlets. But with the passage of time, to broaden its distribution channels and product line, it started to enter into strategic alliances. Schultz said, "When we enter into any partnership, we first assess the quality of the candidate. We look for a company that has brand name recognition and a good reputation in its field, be it hotels or airlines or cruise ships. It must be committed to quality and customer service. We look for people who understand the value of Starbucks and promise to protect our brand and the quality of our coffee. All these factors are weighted before financial considerations."[22]

The first strategic alliance Starbucks entered was with the real estate company Host Marriott wherein Starbucks licensed Marriott to open Starbucks outlets at select airport locations. Starbucks licensed Aramark[23] to open Starbucks stores at a few college campuses. Other partnerships were with the department store Nordstrom, the specialty retailer Barnes & Noble, the Holland America cruise lines, Starwood hotels, Dreyer's Grand Ice Cream, and United Airlines. Under a joint venture with PepsiCo Inc.,[24] a new version of Frappuccino was bottled and sold through grocery stores.

Starbucks maintained a non-smoking policy at all its outlets worldwide. It believed that the smoke could adversely affect the aroma of its coffee. For similar reasons, its employees were required to refrain from using strong perfumes.

Focusing on Asia

In 1994, Starbucks International was formed and Howard Behar became its president. Starbucks pursued international expansion with three objectives in mind: to prevent competitors from getting a head start, to build upon the growing desire for Western brands, and to take advantage of higher coffee consumption rates in different countries.[25] Starbucks entered new markets outside the United States either through joint ventures, licenses, or by company-owned operations. In

1996, Starbucks entered Japan, Hawaii, and Singapore. In 1998, it entered Taiwan, Thailand, New Zealand, and Malaysia, and in 1999, it opened stores in Kuwait, Korea, Lebanon, and China. During the 1990s Starbucks concentrated its expansion efforts mainly in Asia. Schultz said, "The maturity of the coffee market in Europe was very strong and was not going to change much over the years. The Asian market share was in its developmental stage and we had an opportunity to position Starbucks as a leader in a new industry, and in a sense, educate a market about the quality of coffee, the experience, and the idea of Starbucks becoming the third place between home and work in those countries."[26]

Starbucks in Japan

As its first international destination, Starbucks chose Japan because it was the third-largest coffee importer in the world after the United States and Germany and the largest economy in the Pacific Rim. Japan originally was a tea-drinking country and the per capita consumption of coffee in Japan in 1965 was only 300 grams per year.[27] Owing to the decade-long promotional activities of coffee companies and coffee associations, coffee became immensely popular in Japan and by 1990s the per capita consumption of coffee had reached 3.17 kilograms.[28]

In the Japanese coffee industry, specialty blends were the fastest growing segment. Gourmet coffee accounted for 2.5% of the 1.2 billion pounds of coffee imported by Japan annually. The average per capita consumption among gourmet coffee drinkers had doubled from 1990 to 1.5 cups a day in 1997.[29] An industry analyst said, "The Japanese have taken to coffee like a baby to milk."[30]

In 1995, Starbucks entered Japan with a joint venture—Starbucks Coffee Japan, Ltd. with a leading Japanese retailer and restaurant operator, Sazaby Inc. In 1996, Starbucks opened its first shop in the upscale Ginza shopping district, Tokyo, Japan. The décor and logo of the stores were similar to its U.S. stores. The menu remained the same but with slight variations. The store also offered Starbucks coffee beans and coffee-making equipment as well as fresh pastries and sandwiches. The store gathered a huge crowd on the opening day and Japanese lined around the block to get a taste of the Starbucks coffee.

The initial sales volume in Japan was twice as that in the United States. Starbucks rapidly expanded and by 1997 it had 10 stores at prime locations. Despite the slump in economic growth in Japan in the late 1990s, Starbucks remained profitable. Japan had become the most profitable market for Starbucks outside North America. The success of Starbucks and the growing popularity of coffee propelled other players to enter Japan.

By 2002, Starbucks had opened over 360 stores in Japan. But in the same year, Starbucks incurred huge losses in its Japanese operations. According to analysts, Starbucks was opening stores too close to each other, which affected its brand image. Food menu was another reason, for Japanese consumers, food was a major part of the coffee experience. The no-smoking policy of Starbucks also displeased many. As a result many competitors took advantage and included an elaborate food menu with coffee and had separate smoking areas. Other challenges that Japan presented to Starbucks were high rent and cost of labor. The land rent rate in Tokyo was more than double that of Seattle. Moreover, Starbucks did not have a roasting facility in Japan; it had to ship coffee from its roasting facility in Kent.

After cost-cutting exercises and introduction of new products based on consumer research, Starbucks Japan returned to profitability in 2004. By 2006, Starbucks had over 600 retail locations in Japan.[31]

Starbucks in China[32]

A key component of our development in the China market was finding the right business partner who understands the marketplace, and, more importantly, share similar values, vision, and business philosophy.[33]

Howard Schultz

Starbucks had begun its groundwork for entering China since 1994 and entered China in 1999. Starbucks decided to first enter Hong Kong. In Hong Kong, Starbucks created a joint venture, Coffee Concepts (Hong Kong) Ltd., with Maxim's Caterer, a food and beverage company that had 46 years of experience in Hong Kong. Maxim had a thorough know-how of establishing and running businesses in China. Maxim was also the business partner of Hong Kong Land Company, which had cornered a lot of real estate market in Hong Kong. Maxim provided Starbucks with valuable insights about Chinese preferences.

After Hong Kong, Starbucks opened a store at Beijing through a joint venture with Beijing Mei Da Coffee Co. Ltd.[34] The first Starbucks store opened in 1999 at the China World Trade Center, Beijing. The store opening was celebrated according to Chinese traditions. The store offered a complete menu of Starbucks internationally acclaimed coffee beverages, a selection of more than 15 varieties and blends of the finest Arabica coffee beans, freshly baked local pastries and desserts, and a wide selection of coffee brewing equipment, accessories, and service-ware. The ambience and décor of the store were kept similar to its stores in the United States. After Beijing, Starbucks opened stores in Shanghai. As in other markets, Starbucks did not market, advertise, or promote its stores in China and relied mainly on word-of-mouth promotion. Starbucks selected high visibility, high traffic locations to open its stores.

By 2002 Starbucks had expanded to 50 outlets in China. Pedro Man, the then-president of Starbucks Asia Pacific said, "These are still early days of our expansion in the China market. Our approach is very focused. We plan to open one store at a time, serve one customer at a time."[35]

In 2003, Starbucks raised its stake in its joint venture operations in Shanghai to 50%. In mid-2005, Starbucks became the majority owner of its operations in Southern China. The first wholly owned and operated Starbucks store opened in Qingdao[36] in 2005 and by mid-2006, there were nine wholly owned stores in Qingdao, Dalian, and Shenyang.[37]

Starbucks had to face many challenges in China. In its initial years, many were opposed to the opening of a Western coffee chain in China, which was traditionally a tea drinking country. Another challenge it faced was the dominance of instant coffee among coffee drinkers. Specialty coffee was limited to mainly urban consumers. Competition had also grown intense and many domestic and foreign players were setting up specialty coffee shops. Despite the challenges, Starbucks achieved significant success in China and became the leader in specialty coffee. By 2005, China contributed to little less than 10% of the global sales of Starbucks and by 2008, Starbucks expected to derive 20% of its revenue from Chinese locations.[38]

The Next Destination

In 2006, Schultz said,[39] "We are equally excited about two other major markets we intend to enter during 2007—India and Russia (see **Exhibit 3**). We are in discussions with potential joint venture partners. Meanwhile, we are scouting locations, meeting with government officials—all toward gaining additional market knowledge and building critical relationships to make our market entries a success."[40]

About India

India had embarked on a series of economic reforms since 1991. The reforms included liberalization of foreign investment, significant reduction in tariffs and other trade barriers and significant adjustments in government policies.[41] The reforms over the years had resulted in higher growth rates, lower inflation, and significant increase in foreign investment (see **Exhibit 4**). In 2006, India was ranked as the fourth-largest economy in the world in terms of purchasing power parity[42] and the tenth-most-industrialized country in the world.[43] In 2006, the middle class[44] in India was estimated at around 250 million and was growing in double digits in urban and second tier[45] cities.[46] The spending power had increased considerably in the recent years (see **Exhibit 5**). According to a report[47] by KPMG,[48] disposable incomes remained concentrated in urban areas, well-off and affluent classes, and double-income households. Consumers in the age group of 20–45 years were emerging as the fastest growing consumer group.

India's population was one of the youngest in the world and was to remain the youngest in the coming years (see **Exhibit 6**). In 2000, one-third of India's population was below 15 years

EXHIBIT 3
India's Performance against Competing Nations

	Parameter	India	Indonesia	China	Mexico	Philippines	Russia
✚	Availability of workforce-quantity	◑	◑	●	◑	◑	◑
✚	Availability of skilled workforce	◑	◔	◑	◑	◔	◑
✚	Cost of labor	●	●	●	◑	◕	◑
✚	English-language skills	●	◔	◑	◑	◕	◑
✚	Cost and quality of telecom infrastructure	◕	◔	◕	◑	◑	◔
▬	Labor productivity (PPP)(1)	◑	◔	◑	●	◑	◕
▬	Perceived stability of government policies	◑	◔	◕	◑	◑	◔
▬	Perceived operational risk • Risk of personal harm • Risk of business disruption	◔	◔	●	●	◑	◑

● Very favorable ○ Unfavorable

(1) Labor productivity for India highest in IT services vis-à-vis competing nations
Note: Russia and China included as they will compete in specific areas despite aggregate shortages: Israel and Ireland not included because they are not expected to be significant competitors due to lack of manpower

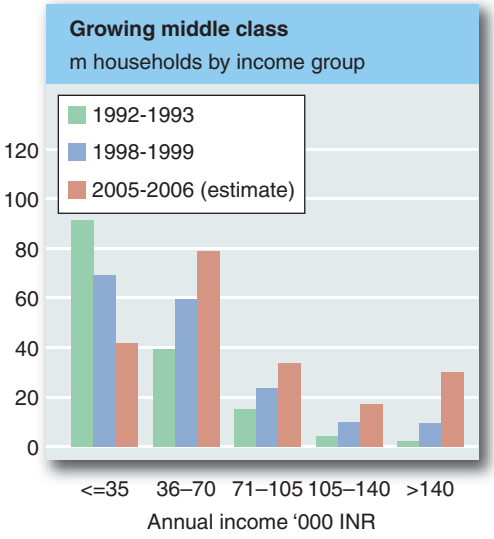
SOURCE: *"India's new opportunity – 2020," Report of the High level strategic group in consultation with The Boston Consulting Group.*

EXHIBIT 4
Pricewaterhouse Coopers 2004/2005 Global Retail & Consumer Study from Beijing to Budapest–India

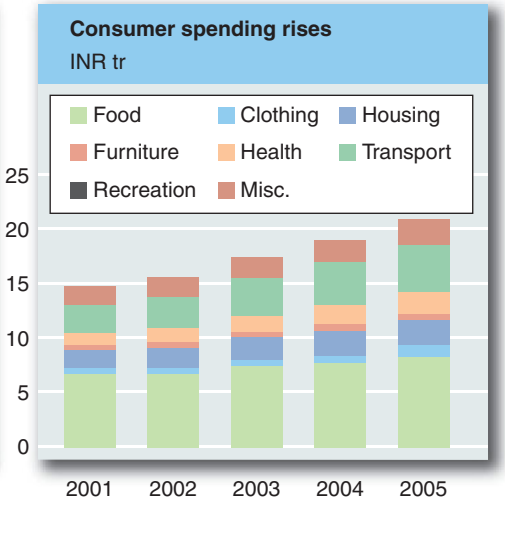
Key economic indicators	1999-00	2000-01	2001-02	2002-03	2003-04
GDP growth (%)	6.0	4.4	5.6	4.3	8.1
CPI (%)	3.4	3.7	4.3	4.0	4.6

SOURCE: *Reserve Bank of India.*

EXHIBIT 5
Growing Middle Class and Increase in Spending



SOURCE: *NCAER, DB Research.*



SOURCE: *MSPI, DB Research.*

EXHIBIT 6
Population Distribution

Aging population	2001	2006 (projected)	2011 (projected)	2016 (projected)
0–14 years (%)	35.6	32.5	29.7	27.1
15–59 years (%)	58.2	60.4	62.5	64.0
60 and above (%)	6.3	7	7.9	8.9

SOURCE: *Statistical Outline of India (2003–2004).*

of age and close to 20% of its people were in the age group of 15–24 years. The population of Indians in the age group of 15–24 years in 2000 was around 190 million, which increased to around 210 million by 2005. The average age of an Indian in 2020 would be 29 years, compared to 37 years in China and the United States, 45 years in Western Europe, and 48 years in Japan.[49] India had emerged as a prime destination for business process outsourcing (BPO) companies, which employed mainly the young people. The real estate market in India was also undergoing a boom.

Mumbai was considered the economic and financial center of India. It housed headquarters of numerous Indian companies and many foreign financial service providers.[50] Many IT companies, financial service providers, and business process outsourcing companies had sprung up in Mumbai. Delhi was the third biggest city in India, had the seat of the government and the most important city in the northern India. Delhi and the neighboring towns of Gurgaon and Noida were established as the call-center hubs. Another prominent city was Bangalore, which was also known as India's Silicon Valley. Many famous Indian and global IT companies were present in Bangalore. In 2005, there were a total of 35 cities with population more than 1 million in India (see **Exhibit 7**).

However, there were certain factors that constrained economic growth. The factors included inadequate infrastructure, bureaucracy, regulatory and foreign investment controls, the reservation of key products for small-scale industries, and high fiscal deficits.[51]

EXHIBIT 7
India's Largest Cities/ Urban Areas

Rank	City / Urban Area	Population
1	Mumbai (Bombay)	16,368,000
2	Kolkata (Calcutta)	13,217,000
3	Delhi	12,791,000
4	Chennai	6,425,000
5	Bangalore	5,687,000
6	Hyderabad	5,534,000
7	Ahmadabad	4,519,000
8	Pune	3,756,000
9	Surat	2,811,000
10	Kanpur	2,690,000
11	Jaipur	2,324,000
12	Lucknow	2,267,000
13	Nagpur	2,123,000
14	Patna	1,707,000
15	Indore	1,639,044
16	Vadodara	1,492,000
17	Bhopal	1,455,000
18	Coimbatore	1,446,000
19	Ludhiana	1,395,000
20	Kochi	1,355,000
21	Visakhapatnam	1,329,000
22	Agra	1,321,000
23	Varanasi	1,212,000
24	Madurai	1,195,000
25	Meerut	1,167,000
26	Nashik	1,152,000
27	Jabalpur	1,117,000
28	Jamshedpur	1,102,000
29	Asansol	1,090,000
30	Dhanbad	1,064,000
31	Faridabad	1,055,000
32	Allahabad	1,050,000
33	Amritsar	1,011,000
34	Vijayawada	1,011,000
35	Rajkot	1,002,000

SOURCE: *India's national census of 2001.*

The Retail Environment

In 2006, the Indian retail market was estimated at US$350 billion. The market was largely unorganized and dominated by small and individually owned businesses. Organized retailing accounted for only 3% of the market, but by 2010, the share was expected to reach over 10%.[52] Modern and organized retail channels such as hypermarkets, supermarkets, department stores, discount stores, etc. were sprouting in a big way. Retailing in grocery accounted for more than three-quarters of overall retailing sales.[53] In 2005, non-grocery retailing grew by 14% in sales value compared to 2004.[54] Department stores were the frontrunners in growth in non-grocery retailing and the number of department stores had grown by 24% per year since 1999–2000.[55] Department stores were largely frequented by the high-income and the upper-middle segment. Specialty retailing was also increasing (see **Exhibit 8**).

In early 2006, the Indian government permitted Foreign Direct Investment (FDI) up to 51% in retail trade of single-brand products with prior government approval. FDI was subjected

EXHIBIT 8
Key Players of the Indian Organized Retail Sector

Food Retail Channels

Category	Company	Group Name	No. of Outlets	Net Sales (2003–04)	Future Plans
Hypermarkets	Big Bazaar	Pantaloon Retail	9	2300	Over 22 stores by 2006
	Giant	RPG Group	2	900	21 stores by 2007
Supermarkets	Food World	RPG (51%) & Dairy Farm (49%)	93	3519	Not Available
	Nilgiris	Nilgiris	30	2550	20 new outlets in 3 years
	Food Bazaar	Pantaloon Retail	12	1650	Over 30 stores by 2006
Discount stores	Subhiksha	Viswapriya group	143	2350	Over 55 new stores by 2006
	Margin free markets	Independent retailer	300	540	Not Available
Cash & Carry	Metro Cash & Carry	Metro Group of Germany	2	650	Wait and watch

Non Food Retail Channels

Category	Company	Group Name	No. of Outlets	Net Sales (2003–04)	Future Plans
Department stores	Shoppers Stop	K Raheja Group	14	4040	11 new stores by 2006, venture in food retailing
	Westside	Trent Ltd.	15	1555	6 new stores by 2006, venture in food retailing
	Lifestyle	Landmark Group	7	2400	13 new stores by 2006
	Globus	R Raheja Group	7	1100	8 new stores by 2006
	Pantaloon	Pantaloon Retail	16	2500	Over 21 stores by 2006
	Ebony	DS Group	8	820	2 new stores by 2006
Specialty retailing	Music World (Music)	RPG Group	125	600	14 new stores by 2006
	Tanishq (Jewelry)	TATA	65	3900	Over 75 stores by 2006
	Health & Glow (Pharma)	RPG Group	24	282	3 new stores by 2006
	Crossword (Book)	Shoppers' Stop (51%), ICICI Ventures (49%)	18	370	Over 28 stores and turnover of 680 million by 2006

SOURCE: *Compiled by IBS, Ahmedabad Research Center from 2004/2005 Global Retail & Consumer Study from Beijing to Budapest – India, www.pwc.com.*

to three conditions; products could be sold under a single brand, the products should be sold under the same brand internationally and the products needed to be branded during manufacturing.[56] Any addition to the product or product categories under the single brand would require fresh government approval.

Many single-brand global retail giants such as Gap and Zara announced their plans to enter India and many were in the exploration stage. Many domestic conglomerates also had big plans. One of the leading Indian conglomerates, Reliance Industries, announced its plans to invest US$3.4 billion in retail in India and establish a chain of 1,575 stores by mid-2007. Another group, K Raheja Group, had plans to open 55 hypermarkets by 2015.[57] In 2006, India was ranked as the top destination for retailers according to A.T. Kearney's[58] Global Retail Development Index (GRDI) (see **Exhibit 9**).

EXHIBIT 9

A. T. Kearney's Global Retail Development Index (GRDI)

2006 Rank	Country	Region	Country Risk	Market Attractiveness	Market Saturation	Time Pressure	GRDI Score
		Weight	**25%**	**25%**	**30%**	**20%**	
1	India	Asia	55	34	89	76	100
2	Russia	Eastern Europe	43	59	53	90	85
3	Vietnam	Asia	43	24	87	81	84
4	Ukraine	Eastern Europe	42	37	76	81	83
5	China	Asia	58	40	57	86	82
6	Chile	Americas	67	57	47	48	71
7	Latvia	Eastern Europe	58	50	31	88	69
8	Slovenia	Eastern Europe	78	52	25	70	68
9	Croatia	Eastern Europe	57	51	28	91	67
10	Turkey	Mediterranean	46	59	64	40	66
11	Tunisia	Mediterranean	58	40	79	25	65
12	Thailand	Asia	57	39	49	72	64
13	Korea, South	Asia	68	73	35	36	63
14	Malaysia	Asia	66	49	54	38	62
15	Macedonia	Eastern Europe	32	32	75	64	61
16	United Arab Emirates	Asia	78	67	33	25	60
17	Saudi Arabia	Asia	53	46	67	30	59
18	Slovakia	Eastern Europe	61	51	23	78	58
19	Mexico	Americas	54	67	47	28	57
20	Egypt	Mediterranean	45	35	81	35	60
21	Bulgaria	Eastern Europe	48	37	52	65	55
22	Romania	Eastern Europe	45	40	53	60	54
23	Hungary	Eastern Europe	65	50	17	76	53
24	Taiwan	Asia	83	69	32	6	52
25	Bosnia and Herzegovina	Eastern Europe	31	18	71	75	51
26	Lithuania	Eastern Europe	59	52	32	55	50
27	Brazil	Americas	46	56	64	16	49
28	Morocco	Mediterranean	45	31	76	30	48
29	Colombia	Americas	39	42	65	37	47
30	Kazakhstan	Asia	48	15	99	8	46
Key	☐ *On the radar screen* ▒ *Lower priority* ■ *To consider*	**Legend**	*0 = high risk 100 = low risk*	*0 = low attractiveness 100 = high attractiveness*	*0 = saturated 100 = not saturated*	*0 = no time pressure 100 = urgency to enter*	

SOURCE: *www.atkearney.com.*

Food Habits

India had a diverse cuisine that varied from region to region. Both vegetarian and nonvegetarian cuisines were eaten. Spicy food and sweets remained popular in India (see **Exhibit 10**). In 2006, a nationwide survey[59] was conducted that threw fresh light on the eating habits of Indians (see **Exhibit 11**).

EXHIBIT 10
Indian Cuisine

In India, the food habits differed across diverse religions and regions. There was no single style of Indian cooking and no single national dish. Styles of cooking and commonly used ingredients differed from region to region and from one household to another. The Hindu and Muslim cultures played a pivotal role in the development of the Indian cuisine. The Portuguese, the Persians, and the British also made important contributions to the Indian cuisine scene.

Overall, wheat and rice were the staple foods. Gravy-based dishes were prominent throughout India. The essence of Indian cooking revolved around the use of spices, which served both as appetizers and digestives. The other main ingredients of Indian cooking were the milk products—ghee and curd. Dals or pulses were also used across the country. Vegetables differed across regions and with seasons. The style of cooking vegetables was dependent upon the main dish or cereal with which they were served. Several customs were associated with the way in which food was consumed. Traditionally, meals were eaten while sitting on the floor or on very low stools, eating with the fingers of the right hand.

The Indian cuisine included a host of beverages, desserts, and paan for a grand finale. Buttermilk, an accompaniment to Indian meals, was made by vigorously churning yogurt and water. It was called lassi in the north and mor or majige in the South. Tender coconut was available in plenty in the coastal areas and was consumed to beat the summer heat.

Coffee was more popular in South India, and tea in North India. Indian tea grown on the mountain slopes of Darjeeling, Munnar, and Coonoor was exported the world over. Coffee was primarily grown in Karnataka.

Bottled drinks included various brands of lime, orange, and cola. Other fruit-based drinks—apple, guava, mango, and tomato—were available in tetra packs and tins. Alcoholic beverages included gin and rum. Fenny, a cashew or palm extract, was popular in Goa.

SOURCE: *Compiled from http://www.geocities.com/Tokyo/Shrine/4287/cuisine.htm.*

EXHIBIT 11
Key Findings of The Hindu-CNN-IBN State of the Nation Survey

Category	Persons	Families*
Vegetarians	31%	21%
Vegetarians who take eggs	9%	3%
Non-Vegetarians	60%	44%
Mixed eating habits	-	32%

*Family includes parents and spouses. Figures are for families where everyone falls in the same category. 32% of families have mixed eating habits.

Those who consume*	Rural	Urban
Tea/Coffee	83	96
Cold drinks	22	44
Eat out in restaurants	-	23

*Figures in percentage for those who consume either daily or once or twice a week or once or twice a month.

SOURCE: *Yogendra Yadav, Sanjay Sharma "The food habits of a nation," www.hinduonnet.com, August 14, 2006.*

Indian Beverage Market

The Indian beverage market is chiefly composed of milk, tea, coffee, bottled water, carbonated soft drinks, fruit beverages, distilled spirits, beer, wine, and others (see **Exhibit 12**). Consumers in different parts of the country had different tastes and preferences. The middle class was the biggest consumer of beverages. Consumption in rural areas had stagnated as a majority of the

EXHIBIT 12
Indian Beverage Market

A. Change in volume by category—2001–2005

Segment	2000/01	2001/02	2002/03	2003/04	2004/05
Milk	3.0%	4.7%	2.1%	2.2%	2.0%
Tea	3.2%	3.1%	3.0%	3.0%	2.9%
Bottled Water	51.9%	63.7%	45.6%	32.7%	23.8%
Coffee	6.7%	6.2%	2.9%	2.0%	2.0%
Carbonated Soft Drinks	20.0%	25.0%	−5.0%	−15.0%	−5.0%
Distilled Spirits	4.3%	14.9%	11.6%	11.3%	10.4%
Beer	7.6%	8.2%	6.6%	5.3%	6.3%
Fruit Beverages	15.6%	20.6%	48.8%	23.9%	23.2%
Wine	—	—	—	18.0%	19.3%
Subtotal	**3.4%**	**4.7%**	**2.9%**	**2.8%**	**2.8%**
All Others[1]	0.8%	0.5%	0.8%	0.9%	0.9%
TOTAL	**1.2%**	**1.2%**	**1.2%**	**1.2%**	**1.2%**

Note: [1]Includes tap water, vegetable juices, powdered drinks, and miscellaneous others.

SOURCE: *Beverage Marketing Corporation.*

B. Per Capita Consumption by Category

	Liters Per Person					
Categories	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Beer	0.5	0.5	0.6	0.6	0.7	0.7
Bottled Water	0.1	0.1	0.1	0.2	0.3	0.5
CSDs	1.0	1.2	1.2	1.5	1.6	1.8
Coffee	2.0	1.2	1.3	1.3	1.3	1.2
Distilled Spirits	0.3	0.3	0.4	0.5	0.6	0.6
Fruit Beverages	0.1	0.1	0.1	0.2	0.2	0.2
Milk	41.2	41.7	40.2	40.7	40.1	40.5
Tea	49.7	50.9	49.2	52.5	48.2	44.2
Wine	0.0	0.0	0.0	0.0	0.0	0.0
Subtotal	**94.9**	**96.0**	**93.1**	**97.5**	**93.0**	**89.7**
All Others*	631.9	630.6	633.6	629.3	633.7	637.0
TOTAL[2]	**726.7**	**726.7**	**726.7**	**726.7**	**726.7**	**726.7**
	Gallons Per Capita					
Categories	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**
Beer	0.1	0.1	0.2	0.2	0.2	0.2
Bottled Water	0.0	0.0	0.0	0.1	0.1	0.1
CSDs	0.3	0.3	0.3	0.4	0.4	0.5
Coffee	0.5	0.3	0.3	0.3	0.3	0.3
Distilled Spirits	0.1	0.1	0.1	0.1	0.1	0.2
Fruit Beverages	0.0	0.0	0.0	0.0	0.0	0.1
Milk	10.9	11.0	10.6	10.8	10.6	10.7
Tea	13.1	13.4	13.0	13.9	12.7	11.7
Wine	0.0	0.0	0.0	0.0	0.0	0.0
Subtotal	**25.0**	**25.2**	**24.5**	**25.8**	**24.4**	**23.8**
All Others[1]	166.9	166.6	167.4	166.3	167.4	168.3
TOTAL[2]	**192.0**	**192.0**	**192.0**	**192.0**	**192.0**	**192.0**

Note: [1]Includes tap water, vegetable juices powders, and miscellaneous others.
[2]Rounding errors

SOURCE: *Beverage Marketing Corporation.*

rural population depended on agricultural products. Also, most of the advertisements were targeted at the urban population living in cities, and very few advertisements targeted the rural market. The Indian hot-beverage market was dominated by tea. India was the largest producer and consumer of tea in the world and accounted for 29% of the total production and over 20% of the total consumption globally.[60] Most of the Indians consumed tea at least twice a day, in the morning and in the afternoon. Tea, perceived as having health benefits, was extensively and easily available, but more than half was available in unpacked or loose form. Milk followed tea as the second-most-popular drink. Coffee was third in the hot beverage market. The total soft drink market (carbonated soft drinks and juices) was estimated at US$1 billion per year. Mineral water market in India was a US$50 million industry.[61]

Indian Coffee Market

Between 1947 and 1996, coffee consumption in India had remained stagnant at 50,000 tons per year. Since 1996, coffee consumption witnessed a steady rise reaching 85,000 tons in 2005.[62] The late 1990s saw the emergence of trendy coffee bars, specialty coffee serving chains that started replacing the conventional and old-fashioned coffee houses.

According to market research studies, coffee was mainly consumed in the urban areas (71%) and to a much lesser extent in the rural areas (29%).[63] The people in southern states of India largely consumed coffee (see **Exhibit 13**). The people in the northern states were generally not coffee drinkers, but drank coffee and experimented with various flavors as a fashion statement. The consumption of instant coffee and filter coffee[64] was almost equal on the national level. But region-wise, filter coffee was more popular in the south and the proportion of instant coffee was very high in the non-south regions.[65] The Coffee Board of India[66] undertook research studies in 2001 and 2003 regarding the consumption of coffee and attitude of coffee drinkers in India (see **Appendix 1**).

The size of the total packaged coffee market was 19,600 tones or US$87 million.[67] According to industry reports, the gourmet coffee market in India in 2004, which was still in its nascent stage, held potential for 5,000 cafes over the next five years.[68] As mentioned by Schultz, "Much like China, India has traditionally been a tea culture, yet there is a growing coffee culture emerging, especially among the country's young adults. Also like China, there is a growing interest in Western consumer brands and luxury products."[69]

Competitive Scenario

Homegrown brands dominated the retail coffee market. Coffee Café Day (CCD) pioneered the concept of specialty coffee in India followed by Qwiky's and Barista Coffee.

EXHIBIT 13
Per Capita Consumption of Coffee in India – State-wise

States	1981	1991	2001
Tamil Nadu	0.633	0.425	0.493
Karnataka	0.498	0.370	0.350
Kerala	0.179	0.070	0.143
AP	0.109	0.062	0.077
Total South	0.362	0.237	0.267
Total for Non-South	0.009	0.004	0.005
Total for all States	**0.094**	**0.076**	**0.062**

SOURCE: *http://indiacoffee.org/newsletter/2004/april/cover_story.html.*

Café Coffee Day

To be the best café chain in the country by offering a world class coffee experience at affordable prices.[70]

CCD Mission statement

CCD, India's first coffee bar was established in 1996 in Bangalore by the largest exporter of coffee in India, the Amalgamated Bean Coffee Trading Company (ABCTCL). By 2002, CCD had 50 outlets in 9 cities, which increased to 326 outlets in 65 cities by 2006.[71] CCD offered a wide variety of Indian and international flavors of hot and cold coffee, hot chocolate, cold drinks, ice creams, pastries, sundaes, quick snacks, and powder coffee.

Customer Profile at CCD

The best-selling item at CCD in summer was Frappe[72] and Cappuccino in winters. In northern states, hot coffee was the most popular. Country-wise, on an average, the sales of cold coffee exceeded the sales of hot coffee.[73]

CCD also sold merchandise such as caps, T-shirts, bags, mugs, mints, and coffee filters at its outlets. Other brands were also promoted in a CCD outlet through innovative and interactive use of posters, cards, danglers, leaflets, contest forms, etc. CCD had tied up with popular television serials and also ran promotion contests for many brands. It had also tied up with some popular Indian movies where CCD was featured in some of the scenes.

By 2006, CCD had six café formats; Music Cafés, Book Cafés, Highway Cafés, Lounge Cafés, Garden Cafés & Cyber Cafés. Music Cafés provided customers with the choice of playing their favorite music tracks on the digital audio jukeboxes installed in the café. CCD had 85 Music Cafés out of which 32 cafés also allowed the customers to watch their favorite music videos through video jukeboxes. Book Cafés offered the customers bestsellers and classic books to read while enjoying coffee. CCD had allied with a leading Indian book distributor for supplying books that would appeal to the customers. There were 15 Book Cafés in 12 cities. There were highway cafés on two important highways in the country that provided coffee and clean restrooms to relax. CCD had three Lounge Cafés at Delhi, Kolkata, and Hyderabad, which provided exquisite interiors, an exotic menu, and theme music. It had hostesses to assist who were looked upon as fashion icons. There were two Garden Cafés at Bangalore and Delhi amidst famous gardens. Cyber Cafés at Bangalore and Delhi allowed the customer to surf while enjoying coffee. CCD had plans to come out with more formats like sports Café, singles café, and fashion café.

In 2006, ABCTCL earned revenues of 3.5 billion INR.[74] It had plans to increase its outlets to 500 by June 2007 by opening 3–4 shops per week and increase its revenue to 10 billion INR.[75]

Speaking on competition with other players, Sudipta SenGupta, marketing head, CCD said: We don't have any competition because we are not competing with the others. In fact we are aiding each other in creating and growing the coffee culture. All of us have a distinct identity. We sure do![76]

Qwiky's

Two software engineers, Shashi Chimala and Shyam, opened the first Qwiky's outlet in Chennai in 1999. They were inspired by the specialty coffee bars in the United States. The menu at Qwiky's included varieties in hot Italian coffee, Indian coffee, specialty hot coffee, cold coffee, frappes, milk shakes, tea, other beverages, desserts, and snacks. It targeted youths in the age group of 18 to 30 years. By 2002, the annual revenues of Qwiky's were 43 million INR.

Qwiky's had three types of formats; Qwiky's Coffee Pubs were stand-alone coffee bars, Qwiky's Coffee Islands were outlets within big stores, multiplexes, and movie theatres, and Qwiky's Coffee Xpress were coffee kiosks. By 2006 it had over 20 outlets in nine cities in India and one franchise in Sri Lanka. Qwiky's had plans to open more outlets in metropolitan and

large cities in India and abroad through franchising its business. It had joined with retailers such as Lifestyle, Music World, and Ebony to open store-in-store outlets.

Barista

The first outlet of Barista Coffee Company Limited (Barista) was established in 2000 in Delhi by an investment company,[77] promoted by Amit Judge. Barista offered a range of hot coffee, international coffee, cold coffee, ice cream, cold non-coffee, ice cream sundaes, add-ons, other beverages, and fast food in their outlets. Coffee and other products at Barista were priced high and its target audiences were youth from the upper-middle-class segment. The coffee at Barista was made with high-quality Arabica coffee beans and baristas (brew masters) were invited from Italy to make new blends. Brotin Banerjee, vice president of marketing, Barista, said, "Our inspiration was the traditional Italian Espresso bars where the idea is to create a 'home away from home.'"[78] In 2001, Barista entered into a strategic alliance with Tata Coffee Ltd. (Tata), the largest coffee producer in India. Tata later acquired a 35% stake in Barista. The alliance allowed Barista to enlarge its distribution network and set up outlets in the Taj Group of hotels owned by Tata and its other allied businesses.

The outlets also offered many merchandise such as mugs, flasks, coffee-made candles, coffee filters, coffee cup miniatures, soft toys, and chocolates.[79] The outlets also gave away gift certificates that could be redeemed at any Barista outlet. By 2003, Barista became a chain of over 100 cafés (mainly in the northern cities), had sales of 650 million INR, and served 35,000 customers daily.[80] It had surpassed CCD in sales, which had over 50 outlets by 2003. In 2004, Amit sold 65.4% stake of the company to an NRI[81] businessman, Sivasankaran (Siva), who later in 2004 bought the remaining stakes from Tata as well. After the acquisition, Siva revamped the chain, opened more Barista outlets in Southern cities, and began franchising its outlets. It started opening up a new outlet every 10 days. A new look was given to its outlets by making changes in its seating arrangements, in-store merchandise, and providing a better youthful ambience of the store.[82] The brew masters maintained friendly relations with the customers and called them by their first names.

Barista joined with specialty retailers such as the music retailer Planet M, the book retailer Crossword, and the Taj Group of hotels for setting up espresso corners in their premises. It also launched a concept called Bancafe, a coffee shop within the bank premises and joined with the bank ABN AMRO.[83] By 2006, Barista had over 130 café chains.

Others

Costa Coffee, owned by the UK-based Whitbread plc, opened its first coffee retail chain in Delhi in late 2005.[84] It entered India through a joint venture agreement with RK Jaipuria Group of India. It had plans to open 300 outlets in India by 2010. Costa coffee, which had 100 outlets in nine countries, was the first international coffee, chain to enter India. In India it priced its coffee, which was locally competitive.

After Costa Coffee, Orlando-based coffee chain Barnie's entered India through a franchising agreement with an Indian company and set up its first outlet at Delhi.[85] The company had plans to invest around 750 million INR and open 300 stores across the country in the next five years. The world's second-largest specialty coffee company, Australia-based Gloria Jean's also disclosed its plans to enter India and set up 20 outlets in seven large cities in India by 2006.[86] Illy, an Italian-based coffee chain, was also in exploration stages to enter India.[87]

The Road Ahead

In 2004, Starbucks had signed an agreement with Tata to source premium coffee beans. Tata had won a gold medal for the best Robusta[88] coffee in the world at the international cupping

competition, Grands Crus de Café held at Paris.[89] The agreement was the first instance when Starbucks decided to source coffee from anyplace other than South America and Indonesia. Tata had met all the stringent standards and conditions followed by Starbucks such as quality, soil, water, pest, waste and energy management, forest and biodiversity conservation to workers' welfare, wages and benefits, living conditions, health, safety, etc. Hamid Ashraff, managing director, Tata Coffee, said, "Starbucks deal with Tata Coffee is yet another significant milestone to show how Indian coffee is gaining acceptance in the international market."[90]

In mid-2006, a Starbucks spokesperson said, "We are excited about the great opportunities that India presents to the company. We are looking forward to offering the finest coffee in the world, handcrafted beverages, the unique Starbucks experience to customers in this country within the next 18 months."[91] Starbucks was said to have been in talks with several probable partners (see **Exhibit 14**) for their much-talked-about entry in India. The marketplace was full of many such speculations that Starbucks had finalized their Indian partner but there was no confirmation from Starbucks. In an interview with a leading Indian newspaper,[92] Coles said, "When we open a new market, we take time to make sure we have the right joint venture partner or licensee to help develop the brand. As it is very important for us to find a partner with the right business and retail experience as well as cultural fit for Starbucks, the process can be a long one. We will open each market when the time is right, one store at a time."[93]

Starbucks sounded firm on its Indian ambitions and seemed prepared to meet the challenges that the Indian market could pose for Starbucks. Starbucks products were priced at a premium and the per capita income in India was lower compared to other markets where it was already present. Coles said, "We price our products competitively in each market, so product prices in India would be locally competitive."[94]

Speaking on competition with the traditional Indian beverage tea, Christine Day, president of Starbucks Asia Pacific Group said, "India is a tea-based culture. We're not saying coffee is a substitute. We're saying Starbucks is a place to hang out, to eat and drink, to see and be seen."[95]

Another significant challenge that Starbucks could face was the increasing rate of obesity and obesity related diseases such as diabetes, high blood pressure, and heart diseases in India. In 2005, 25 million Indians suffered from diabetes, which according to estimates by WHO[96] would increase to 57 million by 2025.[97] Starbucks was said to have been on the target of many consumer health groups worldwide who planned to campaign against the high-calorie and high-fat products that Starbucks sold and which could lead to increased obesity risk, heart diseases,

EXHIBIT 14

Some of the Probable Partners, Starbucks Reported to be in Discussion

Group	Assets	Financials
Anil Dhirubhai Ambani Group (ADAG)	Runs Java Green coffee chain in its Reliance Webworld stores, businesses in energy, finance, telecom. Plans to venture in pharma retail	Operating Profit ADAG Group—INR 50 billion (As on May 2005)
K Raheja Group	Owner of Shopper's Stop, 19 department stores in 10 cities in India (2006)	Shoppers' Stop Revenues—INR 6.75 billion (year ending March 2006)
Pantaloon Retail	Owner of Pantaloons, Big Bazaar, Food Bazaar. 100 stores in 25 cities in India (2005)	Group Revenues—INR 10.73 billion (year ending June 2005)
Planet Sports	Licensee of Starbucks in Indonesia, Licensee of Marks & Spencer in India, 25 stores in India	Turnover in India—INR 0.3–0.4 billion (2005)

SOURCE: *Compiled by IBS Ahmedabad, Research Center.*

and cancer.[98] For instance, Banana Mocha Frappuccino with whipped cream, offered by Starbucks, contained 720 calories and 11 grams of saturated fat.[99] According to the consumer groups, Starbucks should use healthier shortenings[100] and publicize its smallest cup size, short, which was available but did not appear on the menu card. Starbucks provided information about the nutritional value of each of its offerings on its Web site and in-store brochures. The health groups insisted that the information should also be provided on its menu card.[101] A Starbucks official said they were actively researching alternatives to high-fat products.

Starbucks had expressed its interest in entering India several times in recent history. In 2002, Starbucks announced for the first time that it was planning to enter India.[102] Later it postponed its entry as it had entered China recently and was facing problems in Japan. In 2003, there was news again that Starbucks was reviving its plans to enter India. In 2004, Starbucks officials visited India but according to sources they returned unconvinced as they could not agree on an appropriate partner for its entry. Banerjee of Barista said, "We've been hearing about them [Starbucks] coming for the last 3 to 4 years. We don't know why they are not here yet. If they do come, we still believe we have a number of factors to our advantage." Cole commented: Without sounding arrogant, we are looking at our own strategy. There is nothing that keeps us doing business in India."[103]

Appendix 1: Salient Results of the Studies Undertaken by The Coffee Board of India

Consumption of Coffee in India

- Consumption of coffee was 19% when compared to tea at 85%. Consumption was the highest in the South at 31% while it ranged between 35% in the weak coffee zones: North, East, and South.
- Per capita consumption of coffee (among all respondents—both drinkers and non-drinkers) was 0.33 cups against 1.77 cups for tea. However, coffee consumption among drinkers was at 1.76 cups compared with that of tea at 2.1 cups.
- About 41% of the respondents were non-drinkers of coffee and 40% were occasional drinkers.
- Consumption was the highest among the age groups of 15–24 and 35–44 years. The proportion of non-drinkers was the highest in the age group of 55+ years.
- Coffee consumption dipped from 11% at home to 6% outside.
- Coffee was consumed as the first cup only by 23% of coffee drinkers, including in the South.
- Penetration level was found to decrease from higher socioeconomic class (SEC) to the lower socioeconomic class. Penetration of filter coffee was highest in South India. In the rural areas of South India, instant coffee had a higher level of penetration than filter coffee.
- Visiting cafes was not a frequent habit. Of all respondents surveyed, about 12% visited cafes and there was a greater tendency among the upper SECs to visit cafes. About 10% have ever visited cafes; the highest proportion was higher among men and the younger age groups (15–34 years).
- The average number of cups of coffee consumed increased marginally from summer to winter.
- The North had an increased consumption of cold coffee in summer, showing 60% consuming cold coffee at least once a week in summer.
- Around 65% of households bought instant coffee and 18% bought filter coffee. Among filter coffee drinking households, 49% were branded coffee drinkers and 51% were unbranded coffee drinkers. In the South, filter coffee was bought mostly from R&G (Roast & Ground) outlets.
- Amongst coffee consumers in the rural areas, a majority were light drinkers, consuming 1–2 cups every day. About a fifth of rural consumers consumed coffee occasionally.
- A majority of the rural households (71%) bought packaged and branded coffee powder. Of those, 47% bought instant coffee, and 53% filter coffee.

Attitude Toward Coffee Consumption

- Coffee at home was significantly different to coffee outside. Rating for coffee outside home was better than tea outside home, specifically in the North and the East.
- Coffee from vending machines rated significantly more satisfactory in the North as compared to the East or the West. Consumers in the North believed that making filter coffee was time-consuming.
- In the weak coffee markets, the key barriers to coffee appeared to be its bitter taste (East) and its inconsistent taste outside. High price of coffee was also felt as a barrier in the South and the North.

- The knowledge levels on coffee appeared to be relatively weak in the North and East.
- While consumers in the North believed that instant coffee was convenient and tasted good, the seasoned coffee consumer in the South believed that all instant coffee contains chicory and that filter coffee is the gold standard in coffee.
- Respondents in the North, followed by East, appeared to be most positively inclined to consume more coffee at home if the price was less, they were reassured on health, and they could try different recipes.
- Respondents in the North, followed by West and East, appeared to be most positively inclined to consume more coffee outside if the price was less, consistently good coffee was more easily available outside, and they were reassured on health.
- In South, consumers believed that they would consume more coffee at home if their family & friends consumed coffee.
- In the East, there appeared to be a certain level of eagerness to learn about making "just right" coffee and they would make filter coffee if they knew how to make it well.

SOURCE: S. Radhakrishnan "Coffee consumption in India—Perspectives and Prospects," www.indiacoffee.org, April 2004.

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8. Espresso is a strong, flavorful coffee beverage brewed by forcing hot water through finely ground roasted coffee beans. In Italian, espresso means "to press," and refers to the pressure applied to the water as it is forced through the grinds.
9. A person who made coffee drinks as a profession.
10. Howard Schultz, Dori Jones Yang 'Pour your heart into it: How Starbucks built a company one cup at a time,' Hyperion, 1997.
11. Ibid., Pg. 52.
12. Giornale was the name of the largest newspaper company in Italy and also meant 'daily' in general.
13. A shot of coffee mixed with hot steamed milk and up to a half inch of foamed milk on top.
14. Op cit 'Pour your heart into it: How Starbucks built a company one cup at a time,' Pg. 90.
15. 'Planet Starbucks (A),' www.thunderbird.edu, 2003.
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97. Amelia Gentleman 'India's newly rich battle with obesity,' www.indiaresource.org, 4 December 2005.
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CASE 6

Guajilote Cooperativo Forestal, Honduras

Nathan Nebbe and J. David Hunger

GUAJILOTE (PRONOUNCED WA-HEE-LOW-TAY) COOPERATIVO FORESTAL WAS A FORESTRY cooperative that operated out of Chaparral, a small village located in the buffer zone of La Muralla National Park in Honduras' Olancho province. Olancho was one of 18 Honduran provinces and was located inland, bordering Nicaragua. The cooperative was one result of a relatively new movement among international donor agencies promoting sustainable economic development of developing countries' natural resources.[1] A cooperative in Honduras was similar to a cooperative in the United States: It was an enterprise jointly owned and operated by members who used its facilities and services.

Guajilote was founded in 1991 as a component of a USAID (United States Agency for International Development) project. The project attempted to develop La Muralla National Park as an administrative and socioeconomic model that COHDEFOR (the Honduran forestry development service) could transfer to Honduras' other national parks. The Guajilote Cooperativo Forestal was given the right to exploit naturally fallen (not chopped down) mahogany trees in La Muralla's buffer zone. Thus far, it was the only venture in Honduras with this right. A buffer zone was the designated area within a park's boundaries but outside its core protected zone. People were allowed to live and engage in economically sustainable activities within this buffer zone.

In 1998, Guajilote was facing some important issues and concerns that could affect not only its future growth but its very survival. For one thing, the amount of mahogany wood was limited and was increasingly being threatened by forest fires, illegal logging, and slash-and-burn agriculture. If the total number of mahogany trees continued to decline, trade in its wood could be restricted internationally. For another, the cooperative had no way to transport its wood to market and was thus forced to accept low prices for its wood from the only distributor in the area. What could be done to guarantee the survival of the cooperative?

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Operations

Guajilote's work activities included three operations using very simple technologies. First, members searched the area to locate appropriate fallen trees. This, in itself, could be very difficult since mahogany trees were naturally rare. These trees were found at elevations up to 1,800 meters (5,400 feet) and normally were found singly or in small clusters of no more than four to eight trees per hectare (2.2 acres).[2]

Finding fallen mahogany in La Muralla's buffer zone was hampered due to the area's steep and sometimes treacherous terrain. (*La Muralla* means "steep wall of rock" in Spanish.) The work was affected by the weather. For example, more downed trees were available during the wet season due to storms and higher soil moisture—leading to the uprooting of trees.

Second, the cooperative set up a temporary hand-sawmill as close as possible to a fallen tree. Due to the steep terrain, it was often difficult to find a suitable location nearby to operate the hand-sawmill. Once a suitable work location was found, men used a large cross-cut saw to disassemble the tree into various components. The disassembling process was a long and arduous process that could take weeks for an especially large tree. The length of time it took to process a tree depended on the tree's size—mature mahogany trees could be gigantic. Tree size thus affected how many trees Guajilote was able to process in a year.

Third, after a tree was disassembled, the wood was either carried out of the forest using a combination of mule and human power or floated down a stream or river. Even if a stream happened to be near a fallen tree, it was typically usable only during the wet season. The wood was then sold to a distributor who, in turn, transported it via trucks to the cities to sell to furniture makers for a profit.

Guajilote's permit to use fallen mahogany was originally granted in 1991 for a 10-year period by COHDEFOR. The permit was simply written, and stated that if Guajilote restricted itself to downed mahogany, its permit renewal should be granted automatically. The administrator of the area's COHDEFOR office indicated that if things remained as they were, Guajilote should not have any problem obtaining renewal in 2001. Given the nature of Honduran politics, however, nothing could be completely assured.

In 1998, Guajilote's mahogany was still sold as a commodity. The cooperative did very little to add value to its product. Nevertheless, the continuing depletion of mahogany trees around the world meant that the remaining wood should increase in value over time.

Management and Human Resources

Santos Munguia, 29 years old, had been Guajilote's leader since 1995. Although Munguia had only a primary school education, he was energetic and intelligent and had proven to be a very skillful politician. In addition to directing Guajilote, Munguia farmed a small parcel of land and raised a few head of cattle. He was also involved in local politics.

Munguia had joined the cooperative in 1994. Although he had not been one of Guajilote's original members, he quickly became its de facto leader in 1995, when he renegotiated a better price for the sale of the cooperative's wood.

Before Munguia joined the cooperative, Guajilote had been receiving between 3 and 4 lempiras ($0.37, or 11 lempiras to the dollar) per foot of cut mahogany from its sole distributor, Juan Suazo. No other distributors were available in this remote location. The distributor transported the wood to Tegucigalpa or San Pedro Sula and sold it for 16 to 18 lempiras per foot. Believing that Suazo was taking advantage of the cooperative, Munguia negotiated a price increase to 7 to 8 lempiras per foot ($0.60 to $0.62 per foot at the July 15, 1998, exchange rate) by putting political pressure on Suazo. The distributor agreed to the price increase only after a police investigation had been launched to investigate his business dealings. (Rumors

circulated that Suazo was transporting and selling illegally logged mahogany by mixing it with that purchased from Guajilote.)

Munguia: El Caudillo

After renegotiating successfully with the cooperative's distributor, Munguia quickly became the group's caudillo (strong man). The caudillo was a Latin American political and social institution. A caudillo was a (typically male) purveyor of patronage. All decisions went through, and were usually made by, him. A caudillo was often revered, feared, and hated at the same time because of the power he wielded. Munguia was viewed by many in the area as an ascending caudillo because of his leadership of Guajilote.

Guajilote did not operate in a democratic fashion. Munguia made all the decisions—sometimes with input from his second in command and nephew, Miguel Flores Munguia—and handled all of Guajilote's financial matters. Guajilote's members did not seem to have a problem with this management style. The prevailing opinion seemed to be that Guajilote was a lot better off with Munguia running the show by himself than with more involvement by the members. One man put the members' view very succinctly: "Santos, he saved us (from Suazo, from COHDEFOR, from ourselves)."

Guajilote's organizational structure emphasized Munguia's importance. He was alone at the top in his role as decision maker. If, in the future, Munguia became more involved in politics and other ventures that could take him out of Chaparral (possibly for long periods of time), he would very likely be forced to spend less time with Guajilote's operations. Munguia's leadership has been of key importance to Guajilote's maturing as both a work group and as a business. In 1998, there did not seem to be another person in the cooperative that could take Munguia's place.

Guajilote's Members

When founded, the cooperative had been composed of 15 members. Members were initially selected for the cooperative by employees of USAID and COHDEFOR. The number of employees has held steady over time. Since the cooperative's founding, 3 original members have quit; 4 others were allowed to join. Although no specific reasons were given for members leaving, they appeared to be because of personality differences, family problems, or differences of opinion. No money had been paid to them when they left the cooperative. In 1998 there were 16 members in the cooperative.

None of Guajilote's members had any education beyond primary school. Many of the members had no schooling at all and were illiterate. As a whole, the group knew little of markets or business practices.

Guajilote's existence has had an important impact on its members. One member stated that before he had joined Guajilote, he was lucky to have made 2,000 lempiras in a year, whereas he made around 1,000 to 1,500 in one month as a member of the cooperative. He stated that all five of his children were in school, something that he could not have afforded previously. Before joining the cooperative, he had been involved in subsistence farming and other activities that brought in a small amount of money and food. He said that his children had been required previously to work as soon as they were able. As a simple farmer, he often had to leave his family to find work, mostly migrant farm work, to help his family survive. Because of Guajilote, his family now had enough to eat, and he was able to be home with his family.

This was a common story among Guajilote's members. The general improvement in its members' quality of life also appeared to have strengthened the cooperative members' personal bonds with each other.

Financial Situation

No formal public financial records were available. As head of the cooperative, Munguia kept informal records. Guajilote's 1997 revenues were approximately 288,000 lempiras (US$22,153). (Revenues for 1996 were not available.) Guajilote processed around 36,000 feet of wood during 1997. Very little of the money was held back for capital improvement purchases due to the operation's simple material needs. Capital expenditures for 1997 included a mule plus materials needed to maintain Guajilote's large cross-cut saws.

Each of Guajilote's 16 members was paid an average of about 1,500 lempiras (US$113) per month in 1997 and 1,300 lempiras (US$100) per month in 1996. 1998 payments per month had been similar to 1997's payments, according to Guajilote's members. Money was paid to members based on their participation in Guajilote's operations.

There was conjecture, among some workers, that Munguia and his second in charge were paying themselves more than the other members were receiving. When Munguia was asked if he received a higher wage than the others because of his administrative position in the group, he responded that everything was distributed evenly. An employee of COHDEFOR indicated, however, that Munguia had purchased a house in La Union—the largest town in the area. That person conjectured, based on this evidence, that Munguia was likely receiving more from the cooperative than were the other members.

Issues Facing the Cooperative

Guajilote's size and growth potential were limited by the amount of mahogany it could produce in a year. Mahogany was fairly rare in the forest, and Guajilote was legally restricted to downed trees. Moreover, with the difficulties of finding, processing by hand, and then moving the wood out of the forest, Guajilote was further restricted in the quantity of wood it could handle.

Lack of transportation was a major problem for Guajilote. The cooperative had been unable to secure the capital needed to buy its own truck; lending through legitimate sources was very tight in Honduras and enterprises like Guajilote did not typically have access to lines of credit. Although the prices the cooperative was receiving for its wood had improved, the men still thought that the distributor, Juan Suazo, was not paying them what the wood was worth. It was argued that when demand was high for mahogany, the cooperative gave up as much as 10 lempiras per foot in sales to Suazo. Guajilote could conceivably double its revenues if it could somehow haul its wood to Honduras' major market centers and sell it without use of a distributor. The closest market center was Tegucigalpa—three to four hours from Chaparral on dangerous, often rain soaked, mountain roads.

A Possibility

Some of the members of Guajilote wondered if the cooperative could do better financially by skipping the distributor completely. It was possible that some specialty shops (chains and independents) and catalogs throughout the world might be interested in selling high-quality mahogany furniture, i.e., chests or chairs, that were produced in an environmentally friendly manner. Guajilote, unfortunately, had no highly skilled carpenters or furniture makers in its membership. There were, however, a couple towns in Honduras with highly skilled furniture makers who worked on a contract basis.

A U.S. citizen with a furniture export business in Honduras worked with a number of independent furniture makers on contract to make miniature ornamental chairs. This exporter re-

viewed Guajilote's situation and concluded that the cooperative might be able to make and market furniture very profitably—even if it had to go through an exporter to find suitable markets. Upon studying Guajilote's operations, he estimated that Guajilote might be able to more than treble its revenues. In order to do this, however, the exporter felt that Guajilote would have to overcome problems with transportation and upgrade its administrative competence. Guajilote would need to utilize the talents of its members more if it were to widen its operational scope. It would have to purchase trucks and hire drivers to transport the wood over treacherous mountain roads. The role of administrator would become much more demanding, thus forcing Munguia to delegate some authority to others in the cooperative.

Concerns

In spite of Guajilote's improved outlook, there were many concerns that could affect the cooperative's future. A serious concern was the threat of deforestation through fires, illegal logging (i.e., poaching of mahogany as well as clear cutting), and slash-and-burn agriculture.

Small fires were typically set to prepare soils for planting and to help clear new areas for cultivation. Often these fires were either not well supervised or burned out of the control of the people starting them. Due to the 1998 drought, the number of out-of-control forest fires had been far greater than normal. There seemed to be a consensus among Hondurans that 1998 would be one of the worst years for forest fires. Mahogany and tropical deciduous forests are not fire resistant. Fires not only kill adult and young mahogany trees, but they also destroy their seeds.[3] Mahogany could therefore be quickly eliminated from a site. Each year, Guajilote lost more area from which it could take mahogany.

To make matters worse, many Hondurans considered the area around La Muralla National Park to be a frontier open to settlement by landless campesinos (peasant farmers). In fleeing poverty and desertification, people were migrating to the Olancho province in large numbers.[4] Not only did they clear the forests for cultivation, but they also cut wood for fuel and for use in building their homes. Most of the new settlements were being established in the area's best mahogany growing habitats.

Another concern was that of potential restrictions by CITIES (the international convention on trade in endangered species). Although trade in mahogany was still permitted, it was supposed to be monitored very closely. If the populations of the 12 mahogany species continued to decrease, it was possible that mahogany would be given even greater protection under the CITIES framework. This could include even tighter restrictions on the trade in mahogany or could even result in an outright ban similar to the worldwide ban on ivory trading.

NOTES

1. K. Norsworthy, *Inside Honduras* (Albuquerque, NM: Inter-Hemispheric Education Resource, 1993), pp. 133–138.
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CASE 7

Apple Inc.: Performance in a Zero-Sum World Economy

Moustafa H. Abdelsamad, Hitesh (John) Adhia, David B. Croll, Bernard A. Morin, Lawrence C. Pettit Jr., Kathryn E. Wheelen, Richard D. Wheelen, Thomas L. Wheelen II, and Thomas L. Wheelen

On November 1, 2010, John Tarpey, senior financial analyst at a securities firm, was sitting at his conference table to begin the task of fully analyzing the 2010 financial performance and strategic strategies of Apple Inc. On his table were hundreds of articles, reports, SEC documents, and company documents. The basic question he sought answers to with this in-depth analysis was how Apple's performance continued to be outstanding, while the world and U.S. economy was flat to negative.

A second, and more important question, was if Apple could sustain this high level of performance and major innovation. **Exhibit 1** shows unit sales by key products, net sales by the same products, net sales by the company's operating segments, and Mac unit sales by operating segments. John noted that there were nine positive increases versus three negative ones. He saw that the positive increases outnumbered the negative changes by three to one. In 2010, there were only three negative changes compared with nine changes for 2009. Net sales of desktop computers were up 43% in 2010, compared with a 23% drop in sales in 2009.

John considered Apple's Consolidated Statement of Operations (see **Exhibit 2**) and Balance Sheet (see **Exhibit 3**).

This case was prepared by Professors Thomas L. Wheelen, Moustafa H. Abdelsamad, Hitesh (John) Adhia, Professor David B. Croll, Professor Bernard A. Morin, Professor Lawrence C. Pettit Jr., Kathryn E. Wheelen, Richard D. Wheelen, and Thomas L. Wheelen II. Copyright ©2010 by Richard D. Wheelen. The copyright holder is solely responsible for the case content. This case was edited for *Strategic Management and Business Policy*, 13th edition. Reprinted by permission only for the 13th edition of *Strategic Management and Business Policy* (including international and electronic versions of the book). Any other publication of this case (translation, any form of electronic or media) or sale (any form of partnership) to another publisher will be in violation of copyright law unless Richard D. Wheelen has granted additional written reprint permission.

EXHIBIT 1 Selected Sales Information: Apple Inc. (Sales in millions, except unit sales in thousands)

	2010	Change	2009	Change	2008
NET SALES BY OPERATING SEGMENT					
Americas net sales	$24,498	29%	$18,981	15%	$16,552
Europe net sales	18,692	58%	11,810	28%	9,233
Japan net sales	3,981	75%	2,279	32%	1,728
Asia-Pacific net sales	8,256	160%	3,179	18%	2,686
Retail net sales	9,798	47%	6,656	-9%	7,292
Total net sales	$65,225	52%	$42,905	14%	$37,491
MAC UNIT SALES BY OPERATING SEGMENT					
Americas Mac unit sales	4,976	21%	4,120	4%	3,980
Europe Mac unit sales	3,859	36%	2,840	13%	2,519
Japan Mac unit sales	481	22%	395	2%	389
Asia-Pacific Mac unit sales	1,500	62%	926	17%	793
Retail Mac unit sales	2,846	35%	2,115	4%	2,034
Total Mac unit sales	13,662	31%	10,396	7%	9,715
NET SALES BY PRODUCT					
Desktops	$6,201	43%	$4,324	–23%	$5,622
Portables	11,278	18%	9,535	9%	8,732
Total Mac net sales	17,479	26%	13,859	9%	14,354
iPod	8,274	2%	8,091	–12%	9,153
Other music-related products/services	4,948	23%	4,036	21%	3,340
iPhone and related products/services	25,179	93%	13,033	93%	6,742
iPad and related products/services	4,958	–	0	–	0
Peripherals and other hardware	1,814	23%	1,475	–13%	1,694
Software, service, and other sales	2,573	7%	2,411	9%	2,208
Total net sales	$65,225	52%	$42,905	14%	$37,491
UNIT SALES BY PRODUCT					
Desktops	4,627	45%	3,182	–14%	3,712
Portables	9,035	23%	7,214	20%	6,003
Total Mac unit sales	13,662	31%	10,396	7%	9,715
Net sales per Mac unit sold	$1,279	–4%	$1,333	–10%	$1,478
iPod unit sales	50,312	–7%	54,132	–1%	54,828
Net sales per iPod unit sold	$164	10%	$149	–11%	$167
iPhone units sold	39,989	93%	20,731	78%	11,627
iPad units sold	7,458	–	0	–	0

Note: The notes were deleted.

SOURCE: Apple Inc., *SEC 10-K Report,* (September 25, 2010), p. 33.

EXHIBIT 2
Consolidated Statements of Operations: Apple Inc. (Amounts in millions, except share amounts which are reflected in thousands and per share amounts)

Year Ending September 25	2010	2009	2008
NET SALES	$65,225	$42,905	$37,491
Cost of sales	39,541	25,683	24,294
Gross margin	25,684	17,222	13,197
Operating expenses:			
Research and development	1,782	1,333	1,109
Selling, general and administrative	5,517	4,149	3,761
Total operating expenses	7,299	5,482	4,870
Operating income	18,385	11,740	8,327
Other income and expenses	155	326	620
Income before provision for income taxes	18,540	12,066	8,947
Provision for income taxes	4,527	3,831	2,828
NET INCOME	$14,013	$8,235	$6,119
Earnings per common share:			
Basic	$15.41	$9.22	$6.94
Diluted	$15.15	$9.08	$6.78
Shares used in computing earnings per share:			
Basic	909,461	893,016	881,592
Diluted	924,712	907,005	902,139

SOURCE: Apple Inc., *SEC 10-K Form* (September 25, 2010), p.46.

Management's View of the Company[1]

John searched and found in the 10-K report management's views on the company's performance in 2010 as stated below.

First, the company designed, manufactured, and marketed a range of personal computers, mobile communication and media devices, and portable digital music players, and sold a variety of related software, services, peripherals, networking solutions, and third-party digital content and applications. The company's products and services included Mac computers, iPhone, iPad, iPod, Apple TV, Xserve, a portfolio of consumer and professional software applications, the Mac OS X and iOS operating systems, third-party digital content and applications through the iTunes Store, and a variety of accessory, service, and support offerings. The company sold its products worldwide through its retail stores, online stores, and direct sales force, as well as third-party cellular network carriers, wholesalers, retailers, and value-added resellers. In addition, the company sold a variety of third-party Mac, iPhone, iPad, and iPod compatible products, including application software, printers, storage devices, speakers, headphones, and various other accessories and peripherals through its online and retail stores. The company sold to SMB, education, enterprise, government, and creative markets.

Second, the company was committed to bringing the best user experience to its customers through its innovative hardware, software, peripherals, services, and Internet offerings. The company's business strategy leverages its unique ability to design and develop its own operating systems, hardware, application software, and services to provide its customers new products and solutions with superior ease-of-use, seamless integration, and

EXHIBIT 3
Consolidated Balance Sheets: Apple Inc. (Dollar amounts in millions, except share amounts)

Years Ending September 30	2010	2009
ASSETS		
Current assets		
Cash and cash equivalents	$ 11,261	$ 5, 263
Short-term marketable securities	14,359	18,201
Accounts receivable, less allowances of $55 and $52, respectively	5,510	3,361
Inventories	1,051	455
Deferred tax assets	1,636	1,135
Vendor non-trade receivables	4,414	1,696
Other current assets	3,447	1,444
Total current assets	41,678	31,555
Long-term marketable securities	$ 25,391	$ 10,528
Property, plant, and equipment, net	4,768	2,954
Goodwill	741	206
Acquired intangible assets, net	342	247
Other assets	2,263	2,011
Total assets	$ 75,183	$ 47,501
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$ 12,015	$ 5,601
Accrued expenses	5,723	3,852
Deferred revenue	2,984	2,053
Total current liabilities	20,722	11,506
Deferred revenue—non-current	1,139	853
Other non-current liabilities	5,531	3,502
Total liabilities	27,392	15,861
Commitments and contingencies		
Shareholders' equity		
Common stock, no par value; 1,800,000,000 shares authorized; 915,970,050, and 899,805,500 shares issued and outstanding, respectively	10,668	8,210
Retained earnings	37,169	23,353
Accumulated other comprehensive (loss)/income	–46	77
Total shareholders' equity	47,791	31,640
Total Liabilities and Stockholders' Equity	$ 75,183	$ 47,501

SOURCE: Apple Inc., *SEC 10-K Form* (September 25, 2010).

innovative industrial design. The company believed continual investment in research and development was critical to the development and enhancement of innovative products and technologies. In conjunction with its strategy, the company continued to build and host a robust platform for the discovery and delivery of third-party digital content and applications through the iTunes Store. Within the iTunes Store, the company expanded its offerings through the App Store and iBookstore, which allowed customers to browse, search for, and purchase third-party applications and books through either a Mac or Windows-based computer or by wirelessly downloading directly to an iPhone, iPad, or iPod touch. The company

also worked to support a community for the development of third-party software and hardware products and digital content that complement the company's offerings. Additionally, the company's strategy included expanding its distribution network to effectively reach more customers and provide them with a high-quality sales and post-sales support experience. The company was therefore uniquely positioned to offer superior and well-integrated digital lifestyle and productivity solutions.

Third, the company participated in several highly competitive markets, including personal computers with its Mac computers; mobile communications and media devices with its iPhone, iPad, and iPod product families; and distribution of third-party digital content and applications with its online iTunes Store. While the company was widely recognized as a leading innovator in the markets where it competes, these markets were highly competitive and subject to aggressive pricing. To remain competitive, the company believed that increased investment in research and development, marketing, and advertising was necessary to maintain or expand its position in these markets. The company's research and development spending was focused on further developing its existing Mac line of personal computers; the Mac OS X and iOS operating systems; application software for the Mac; iPhone, iPad, and iPod and related software; development of new digital lifestyle consumer and professional software applications; and investments in new product areas and technologies. The company also believed increased investment in marketing and advertising programs was critical to increasing product and brand awareness.

The company utilized a variety of direct and indirect distribution channels, including its retail stores, online stores, and direct sales force, as well as third-party cellular network carriers, wholesalers, retailers, and value-added resellers. The company believed that sales of its innovative and differentiated products were enhanced by knowledgeable salespersons who could convey the value of the hardware, software, and peripheral integration; demonstrate the unique digital lifestyle solutions that were available on its products; and demonstrate the compatibility of the Mac with the Windows platform and networks. The company further believed providing direct contact with its targeted customers was an effective way to demonstrate the advantages of its products over those of its competitors, and that providing a high-quality sales and after-sales support experience is critical to attracting new—and retaining existing—customers. To ensure a high-quality buying experience for its products in which service and education were emphasized, the company continued to expand and improve its distribution capabilities by expanding the number of its own retail stores worldwide. Additionally, the company invested in programs to enhance reseller sales by placing high-quality Apple fixtures, merchandising materials, and other resources within selected third-party reseller locations. Through the Apple Premium Reseller Program, certain third-party resellers focused on the Apple platform by providing a high level of integration and support services, as well as product expertise.

History of Apple Inc.[2]

The history of Apple can be broken into five separate time periods, each with its own strategic issues and concerns.

1976–1984: The Founders Build a Company

Founded in a California garage on April 1, 1976, Apple created the personal computer revolution with powerful yet easy-to-use machines for the desktop. Steve Jobs sold his Volkswagen bus and Steve Wozniak hocked his HP programmable calculator to raise $1,300 in seed money to start their new company. Not long afterward, a mutual friend helped recruit A. C. "Mike" Markkula to help market the company and give it a million-dollar image. Even

though all three founders had left the company's management team during the 1980s, Markkula continued serving on Apple's Board of Directors until August 1997.

The early success of Apple was attributed largely to marketing and technological innovation. In the high-growth industry of personal computers in the early 1980s, Apple grew quickly, staying ahead of competitors by contributing key products that stimulated the development of software for the computer. Landmark programs such as Visicalc (forerunner to Lotus 1-2-3 and other spreadsheet programs) were developed first for the Apple II. Apple also secured early dominance in the education and consumer markets by awarding hundreds of thousands of dollars in grants to schools and individuals for the development of education software.

Even with enormous competition, Apple revenues continued to grow at an unprecedented rate, reaching $583.3 million by fiscal 1982. The introduction of the Macintosh graphical user interface in 1984, which included icons, pull-down menus, and windows, became the catalyst for desktop publishing and instigated the second technological revolution attributable to Apple. Apple kept the architecture of the Macintosh proprietary; that is, it could not be cloned like the "open system" IBM PC. This allowed the company to charge a premium for its distinctive "user-friendly" features.

A shakeout in the personal computer industry began in 1983 when IBM entered the PC market, initially affecting companies selling low-priced machines to consumers. Companies that made strategic blunders or that lacked sufficient distribution or brand awareness of their products disappeared.

1985–1997: Professional Managers Fail to Extend the Company

In 1985, amid a slumping market, Apple saw the departure of its founders, Jobs and Wozniak. As Chairman of the Board, Jobs had recruited John Sculley, an experienced executive from PepsiCo, to replace him as Apple's CEO in 1983. Jobs had challenged Sculley when recruiting him by saying, "Do you want to spend the rest of your life selling sugared water, or do you want to change the world?" Jobs willingly gave up his title as CEO so that he could have Sculley as his mentor. In 1985, a power struggle took place between Sculley and Jobs. With his entrepreneurial orientation, Jobs wanted to continue taking the company in risky new directions. Sculley, in contrast, felt that Apple had grown to the point where it needed not only to be more careful in its strategic moves, but also better organized and rationally managed. The board of directors supported Sculley's request to strip Jobs of his duties, since it felt that the company needed an experienced executive to lead Apple into its next stage of development.

Jobs then resigned from the company he had founded and sold all but one share of his Apple stock. Under the leadership of John Sculley, CEO and Chairman, the company engineered a remarkable turnaround. He instituted a massive reorganization to streamline operations and expenses. During this time Wozniak left the company. Macintosh sales gained momentum throughout 1986 and 1987. Sales increased 40% from $1.9 billion to $2.7 billion in fiscal 1987, and earnings jumped 41% to $217 million.

In the early 1990s, Apple sold more personal computers than any other computer company. Net sales grew to over $7 billion, net income to over $540 million, and earnings per share to $4.33. The period from 1993 to 1995 was, however, a time of considerable change in the management of Apple. The industry was rapidly changing. Personal computers using Microsoft's Windows operating system and Office software plus Intel microprocessors began to dominate the personal computer marketplace. (The alliance between Microsoft and Intel was known in the trade as Wintel.) Dell, Hewlett-Packard, Compaq, and Gateway replaced both IBM and Apple as

the primary makers of PCs. The new Windows system had successfully imitated the user-friendly "look and feel" of Apple's Macintosh operating system. As a result, Apple lost its competitive edge. In June 1993, Sculley was forced to resign and Michael H. Spindler was appointed CEO of the company. At this time, Apple was receiving a number of offers to acquire the company. Many of the company's executives advocated Apple's merging with another company. However, when no merger took place, many executives chose to resign.

Unable to reverse the company's falling sales, Spindler was soon forced out and Gilbert Amelio was hired from outside Apple to serve as CEO. Amelio's regime presided over an accelerated loss of market share, deteriorating earnings, and stock that had lost half of its value. Apple's refusal to license the Mac operating system to other manufacturers had given Microsoft the opening it needed to take the market with its Windows operating system. Wintel PCs now dominated the market—pushing Apple into a steadily declining market niche composed primarily of artisans and teachers. By 1996, Apple's management seemed to be in utter disarray.

Looking for a new product with which Apple could retake the initiative in personal computers, the company bought NeXT for $402 million on December 20, 1996. Steve Jobs, who formed the NeXT computer company when he left Apple, had envisioned his new company as the developer of the "next generation" in personal computers. Part of the purchase agreement was that Jobs would return to Apple as a consultant. In July of 1997, Amelio resigned and was replaced by Steve Jobs as Apple's interim CEO (iCEO). This ended Steve Jobs' 14-year exile from the company that he and Wozniak had founded. In addition to being iCEO of Apple, Jobs also served as CEO of Pixar, a company he had personally purchased from Lucasfilm for $5 million. Receiving only $1.00 a year as CEO of both Pixar and Apple, Jobs held the Guinness World Record as the "Lowest Paid Chief Executive Officer."

1998–2001: Jobs Leads Apple "Back to the Future"

Once in position as Apple's CEO, Steve Jobs terminated many of the company's existing projects. Dropped were the iBook and the AirPort products series, which had helped popularize the use of wireless LAN technology to connect a computer to a network.

In May 2001, the company announced the reopening of Apple Retail Stores. Like IBM and Xerox, Apple had opened its own retail stores to market its computers during the 1980s. All such stores had been closed however, when Wintel-type computers began being sold by mass merchandisers, such as Sears and Circuit City, as well as through corporate websites.

Apple introduced the iPod portable digital audio player, and the company opened its own iTunes music store to provide downloaded music to iPod users. Given the thorny copyright issues inherent in the music business, analysts doubted if the new product would be successful.

2002–2006: A Corporate Renaissance?

In 2002, Apple introduced a redesigned iMac using a 64-bit processor. The iMac had a hemispherical base and a flat-panel all-digital display. Although it received a lot of press, the iMac failed to live up to the company's sales expectations.

In 2004 and 2005, Apple opened its first retail stores in Europe and Canada. By November 2006, the company had 149 stores in the United States, 4 stores in Canada, 7 stores in the United Kingdom, and 7 stores in Japan.

In 2006, Jobs announced that Apple would sell an Intel-based Macintosh. Previously, Microsoft had purchased all of its microprocessors from Motorola. By this time, Microsoft's

operating system with Intel microprocessors was running on 97.5% of the personal computers sold, with Apple having only a 2.5% share of the market. The company also introduced its first Intel-based machines, the iMac and MacBook Pro.

By this time, Apple's iPod had emerged as the market leader of a completely new industry category, which it had created. In 2006, Apple controlled 75.6% of the market, followed by SunDisk with 9.7%, and Creative Technology in third place with 4.3%. Although one analyst predicted that more than 30 million iPods would be sold in fiscal 2006, Apple actually sold 41,385,000. Taking advantage of its lead in music downloading, the company's next strategic move was to extend its iTunes music stores by offering movies for $9.99 each. An analyst reviewing this strategic move said that Apple was able to create a $1 billion-a-year market for the legal sale of music. Apple may be able to provide the movie industry with a similar formula.

2007–Present: Mobile Consumer Electronics Era

While delivering his keynote speech at the Macworld Expo on January 9, 2007, Jobs announced that Apple Computer, Inc. would from that point on be known as Apple Inc., due to the fact that computers were no longer the singular focus for the company. This change reflected the company's shift of emphasis to mobile electronic devices from personal computers. The event also saw the announcement of the iPhone and the Apple TV. The following day, Apple shares hit $97.80, an all-time high at that point. In May, Apple's share price passed the $100 mark. In an article posted on Apple's website on February 6, 2007, Steve Jobs wrote that Apple would be willing to sell music on the iTunes Store with DRM (which would allow tracks to be played on third-party players) if record labels would agree to drop the technology. On April 2, 2007, Apple and EMI jointly announced the removal of DMR technology from EMI's catalog in the iTunes Store, effective in May. Other record labels followed later that year.

In July of the following year, Apple launched the App Store to sell third-party applications for the iPhone and iPod Touch. Within a month, the store sold 60 million applications and brought in $1 million daily on average, with Jobs speculating that the App Store could become a billion-dollar business for Apple. Three months later, it was announced that Apple had become the third-largest mobile handset supplier in the world due to the popularity of the iPhone.

On December 16, 2008, Apple announced that, after over 20 years, 2009 would be the last year Steve Jobs would be attending the Macworld Expo, and that Phil Schiller would deliver the 2009 keynote speech in lieu of the expected Jobs. Almost exactly one month later, on January 14, 2009, an internal Apple memo from Jobs announced that he would be taking a six-month leave of absence, until the end of June 2009, to allow him to better focus on his health and to allow the company to better focus on its products without having the rampant media speculating about his health. Despite Jobs' absence, Apple recorded its best non-holiday quarter (q1 FY 2009) during the recession with revenue of $8.16 billion and a profit of $1.21 billion.

After years of speculation and multiple rumored "leaks," Apple announced a large screen, tablet-like media device known as the iPad on January 27, 2010. The iPad ran the same touch-based operating system that the iPhone used and many of the same iPhone apps were compatible with the iPad. This gave the iPad a large app catalog on launch even with very little development time before the release. Later that year on April 3, 2010, the iPad was launched in the United States and sold more than 300,000 units on that day, reaching 500,000 by the end of the first week. In May 2010, Apple's market cap exceeded that of competitor Microsoft for the first time since 1989.

In June 2010, Apple released the fourth generation iPhone, which introduced video calling, multitasking, and a new insulated stainless steel design which served as the phone's antenna. Because of this antenna implementation, some iPhone 4 users reported a reduction in signal strength when the phone was held in specific ways. Apple offered buyers a free rubber "bumper" case until September 30, 2010, as cases had been developed to solve/improve the signal strength issue.

In September 2010, Apple refreshed its iPod line of MP3 players, introducing a multi-touch iPod Nano, iPod Touch with FaceTime, and iPod Shuffle with buttons. In October 2010, Apple shares hit an all-time high, eclipsing $300. Additionally, on October 20, Apple updated its MacBook Air laptop, iLife suite of applications, and unveiled Mac OS X Lion, the latest installment in its Mac OS X operating system. On November 16, 2010, Apple Inc., after years of negotiations, finalized a deal to allow iTunes to sell The Beatles' music at $1.29 per song. The five major Web-TV boxes were (1) Apple TV, (2) Boxee, (3) Google TV, (4) WD TV Hub, and (5) Roku.

Steven P. Jobs: Entrepreneur and Corporate Executive[3]

In 2010, Steve Jobs was chosen as "Executive of the Decade" by *Fortune* magazine. He has also been referred to as the "Henry Ford" of the current world business market. Steven P. Jobs was born on February 24, 1955, in San Francisco. He was adopted by Paul and Clara Jobs in February 1955. In 1972, Jobs graduated from Homestead High School in Los Altos, California. His high school electronics teacher said, "He was somewhat of a loner and always had a different way of looking at things." After graduation, Jobs was hired by Hewlett-Packard as a summer employee. This is where he met Steve Wozniak, a recent dropout from The University of California at Berkeley. Wozniak had a genius IQ and was an engineering whiz with a passion for inventing electronic gadgets. At this time, Wozniak was perfecting his "blue box," an illegal pocket-size telephone attachment that allowed the user to make free long-distance calls. Jobs helped Wozniak sell this device to customers.[4]

In 1972, Jobs enrolled at Reed College in Portland, Oregon, but dropped out after one semester. He remained around Reed for a year and became involved in the counterculture. During that year, he enrolled in various classes in philosophy and other topics. In a later speech at Stanford University, Jobs explained, "If I had never dropped in on that single course (calligraphy), that Mac would have never had multiple typefaces or proportionally spaced fonts."[5]

In early 1974, Jobs took a job as a video-game designer for Atari, a pioneer in electronic arcade games. After earning enough money, Jobs went to India in search of personal spiritual enlightenment. Later that year, Jobs returned to California and began attending meetings of Steve Wozniak's "Homebrew Computer Club." Wozniak converted his TV monitor into what would become a computer. Wozniak was a very good engineer and extremely interested in creating new electronic devices. Although Jobs was not interested in developing new devices, he realized the marketability of Wozniak's converted TV. Together they designed the Apple I computer in Jobs' bedroom and built the first prototype in Jobs' garage. Jobs showed the Apple I to a local electronics retailer, the Byte Shop, and received a $25,000 order for 50 computers. Jobs took this purchase order to Cramer Electronics to order the components needed to assemble the 50 computers.

The local credit manager asked Jobs how he was going to pay for the parts and he replied, "I have this purchase order from the Byte Shop chain of computer stores for 50 of my computers and the payment terms are COD. If you give me the parts on net 30 day terms, I can build and deliver the computers in that time frame, collect my money from Turrell at the Byte Shop

and pay you." With that, the credit manager called Paul Turrell, who was attending an IEEE computer conference, and verified the validity of the purchase order. Amazed at the tenacity of Jobs, Turrell assured the credit manager that if the computers showed up in his stores Jobs would be paid and would have more than enough money to pay for the parts order. The two Steves and their small crew spent day and night building and testing the computers and delivered them to Turrell on time to pay his suppliers and have a tidy profit left over for their celebration and next order. Steve Jobs had found a way to finance his soon-to-be multimillion dollar company without giving away one share of stock or ownership.[6]

Jobs and Wozniak decided to start a computer company to manufacture and sell personal computers. They contributed $1,300 of their own money to start the business. Jobs selected the name Apple for the company based on his memories of a summer job as an orchard worker. On April 1, 1976, Apple Computer company was formed as a partnership.

During Jobs' early tenure at Apple, he was a persuasive and charismatic evangelist for the company. Some of his employees have described him at that time as an erratic and tempestuous manager. An analyst said that many persons who look at Jobs' management style forget that he was 30 years old in 1985 and he received his management and leadership education on the job. Jobs guided the company's revenues to $1,515,616,000 and profits of $64,055,000 in 1984. Jobs was cited in several articles as having a demanding and aggressive personality. One analyst said that these two attributes described most of the successful entrepreneurs. Jobs strategically managed the company through a period of new product introduction, rapidly changing technology, and intense competition—a time during which many companies have failed.

In 1985, after leaving Apple, Jobs formed a new computer company, NeXT Computer Inc. Jobs served as Chairman and CEO.[7] NeXT was a computer company that built machines with futuristic designs and ran the UNIX-derived NeXT step operating system. It was marketed to academic and scientific organizations. NeXT was not a commercial success, however, in part because of its high price.

In 1986, Jobs purchased Pixar Animation from Lucasfilm for $5 million. He provided another $5 million in capital, owned 50.6% of the stock, and served as Chairman and CEO. Pixar created three of the six highest grossing domestic (gross revenues) animated films of all time—*Toy Story* (1995), *A Bug's Life* (1998), and *Toy Story 2* (1999). Each of these films, released under a partnership with the Walt Disney Company, was the highest grossing animated film for the year in which it was released. During this period, Jobs delegated more to his executives. Many analysts felt that the excellent executive staff and animators were prime reasons that Disney management subsequently wanted to acquire Pixar. Jobs served as CEO of NeXT and Pixar from 1985 to 1997. Jobs ultimately sold NeXT in 1996 to Apple for $402 million and became iCEO of Apple in July 1997.[8]

At Pixar, Jobs focused on business duties, which was different than his earlier management style at Apple. The creative staff was given a great deal of autonomy. Sources say he spent less than one day a week at the Pixar campus in Emeryville, just across the San Francisco Bay from Apple's headquarters. A Pixar employee said, "Steve did not tell us what to do." He further stated, "Steve's our benevolent benefactor."[9]

Michael D. Eisner, CEO of the Walt Disney Company, did not have a smooth relationship with Jobs during the years of the Pixar/Disney partnership. Critics explained that Eisner was unable to work with Jobs because both men were supremely confident (some said arrogant) that their own judgment was correct—regardless of what others said. In 2005, in response to Eisner's unwillingness to modify Disney's movie distribution agreement with Pixar, Jobs refused to renew the contract. At the time, Disney's own animation unit was faltering and unable to match Pixar's new computer technology and creativity. Concerned with Eisner's leadership style and his inability to support the company's distinctive competence in animation, Roy Disney led a shareholders' revolt. On October 1, 2005, Eisner was replaced by Robert A. Iger as CEO of Disney.[10]

On January 24, 2006, CEO Iger announced that Disney had agreed to pay $7.4 billion in stock to acquire Pixar Animation Studios. Since this deal made Jobs the largest stockholder (6.67%) in Disney, he was appointed to Disney's board of directors.[11]

Edward S. Woodward Jr., former chairman of Apple Computer, told Apple's board of directors, "He (Jobs) has a good relationship with you; there is nobody better with you; there is nobody better in the world to work with. Iger made a very wise move, and two years from now everyone will be saying that."[12]

Peter Burrows and Ronald Grover stated in an article: "The alliance between Jobs and Disney is full of promise. If he can bring to Disney the same kind of industry-sharing, boundary-busting energy that has lifted Apple and Pixar sky-high, he could help the staid company become the leading laboratory for media convergences. It's not hard to imagine a day when you could fire up your Apple TV and watch net-only spin-offs of popular TV shows from Disney's ABC Inc. (DIS). Or use your Apple iPhone to watch Los Angeles Lakers superstar Kobe Bryant's video blog delivered via Disney's ESPN Inc. 'We've been talking about a lot of things,' said Jobs. 'It's going to be a pretty exciting world looking ahead over the next five years'."[13]

An expert on Jobs asked, "*So what is Jobs' secret*?" His answer: "There are many, but it starts with focus and a non-religious faith in his strategy." In his return to Apple, he took a proprietary approach as he cut dozens of projects and products. Many on Wall Street were not initially happy with Jobs' new directions for the company, but soon were impressed by Apple's successful turnaround.[14]

Jim Cramer, host of *Mad Money*, has said several times on his television program that Steve Jobs is the "Henry Ford" of this period of America's industry. Others claim Steve is the present Thomas Edison. Steve Jobs over the years has received many honors, such as the National Medal of Technology (with Steve Wozniak) from President Reagan in 1985. Jobs was among the first people to ever receive the honor, and a Jefferson Award for Public Service in the category "Greatest Public Service by an Individual 35 Years or Under" (a.k.a. the *Samuel S. Beard Award*) in 1987. On November 27, 2007, California Governor Arnold Schwarzenegger and First Lady Maria Shriver inducted Jobs into the California Hall of Fame, located at the California Museum for History, Women and the Arts. In August 2009, Jobs was selected the most admired entrepreneur among teenagers on a survey by Junior Achievement. On November 5, 2009, Jobs was named the CEO of the decade by *Fortune* Magazine. On November 22, 2010, *Forbes* Magazine named Steve Jobs the "17th Most Powerful Person on Earth." The list had only 68 individuals out of the world population of 6.8 billion people.[15]

Health Concerns

In mid-2004, Jobs announced to his employees that he had been diagnosed with a cancerous tumor in his pancreas. The prognosis for pancreatic cancer was usually very grim; Jobs, however, stated that he had a rare, far less aggressive type known as islet cell neuro-endocrine tumor. After initially resisting the idea of conventional medical intervention and embarking on a special diet to thwart the disease, Jobs underwent a pancreaticoduodenectomy (or "Whipple procedure") in July 2004 that appeared to successfully remove the tumor. Jobs apparently did not require nor receive chemotherapy or radiation therapy. During Jobs' absence, Timothy D. Cook, head of worldwide sales and operations at Apple, ran the company.

In early August 2006, Jobs delivered the keynote speech for Apple's annual Worldwide Developers Conference. His "thin, almost gaunt" appearance and unusually "listless" delivery, together with his choice to delegate significant portions of his keynote speech to other presenters, inspired a flurry of media and Internet speculation about his health. In contrast, according to an *Ars Technica* journal report, WWDC attendees who saw Jobs in person said he "looked fine"; following the keynote, an Apple spokesperson said that "Steve's health is robust."

Two years later, similar concerns followed Jobs' 2008 WWDC keynote address; Apple officials stated Jobs was victim to a "common bug" and that he was taking antibiotics, while others surmised his cachectic appearance was due to the Whipple procedure. During a July conference call discussing Apple earnings, participants responded to repeated questions about Steve Jobs' health by insisting that it was a "private matter." Others, however, opined that shareholders had a right to know more, given Jobs' hands-on approach to running his company. The *New York Times* published an article based on an off-the-record phone conversation with Jobs, noting that "while his health issues have amounted to a good deal more than 'a common bug,' they weren't life-threatening and he doesn't have a recurrence of cancer."

On August 28, 2008, Bloomberg mistakenly published a 2,500-word obituary of Jobs in its corporate news service, containing blank spaces for his age and cause of death. (News carriers customarily stockpile up-to-date obituaries to facilitate news delivery in the event of a well-known figure's untimely death.) Although the error was promptly rectified, many news carriers and blogs reported on it, intensifying rumors concerning Jobs' health. Jobs responded at Apple's September 2008 Let's Rock keynote by quoting Mark Twain: "Reports of my death are greatly exaggerated"; at a subsequent media event, Jobs concluded his presentation with a slide reading "110 / 70," referring to his blood pressure, stating he would not address further questions about his health.

On December 16, 2008, Apple announced that Marketing Vice-President Phil Schiller would deliver the company's final keynote address at the Macworld Conference and Expo 2009, again reviving questions about Jobs' health. In a statement given on January 5, 2009, on Apple.com, Jobs said that he had been suffering from a "hormone imbalance" for several months. On January 14, 2009, in an internal Apple memo, Jobs wrote that in the previous week he had "learned that my health-related issues are more complex than I originally thought" and announced a six-month leave of absence until the end of June 2009 to allow him to better focus on his health. Tim Cook, who had previously acted as CEO in Jobs' 2004 absence, became acting CEO of Apple, with Jobs still involved with "major strategic decisions."

In April 2009, Jobs underwent a liver transplant at Methodist University Hospital Transplant Institute in Memphis, Tennessee. Jobs' prognosis was "excellent."[16]

On June 29, 2010, Steve Jobs returned to his position as leader at Apple. Jobs had about 10 serious discussions with associates about the possibility of him not returning to active management at Apple, and what impact his decision would have on Apple's future success. Most felt that if Steve departed Apple, "Apple's future success was in question."[17]

Surprised Leave of Absence Announced—2011

On January 17, 2011, Steve Jobs sent the following e-mail to all Apple employees:

> Team,
>
> At my request, the board of directors has granted me a medical leave of absence so I can focus on my health. I will continue as CEO and be involved in major strategic decisions for the company.
>
> I have asked Tim Cook to be responsible for all of Apple's day to day operations. I have great confidence that Tim and the rest of the executive management team will do a terrific job executing plans we have in place for 2011.
>
> I love Apple so much and hope to be back as soon as I can. In the meantime, my family and I would deeply appreciate respect for our privacy.
>
> **Steve**

This was Job's second leave of absence. The first one was from January 2009 until June 2009.

Tim Cook, chief operating officer, again took over the day-to day activities of the CEO position, but Jobs kept the title as he did on his first leave of absence. After Jobs' first medical leave of absence was granted in January 2009, a 10% drop occurred in the stock. On January 19, 2011, the stock's close price was $348.48; as of the last trade January 20, it was $340.65 (a change down $7.83 or 2.25%).[18] This was not in line with the trading in the past month.

The following is Timothy (Tim) Cook's biography sketch as it appeared in the Apple Inc. 2011 Proxy Statement:

> ***Timothy D. Cook**, (50) Chief Operating Officer, joined the company in March 1998. Mr. Cook also served as Executive Vice President, Worldwide Sales Operations from 2002 to 2005. In 2004, his responsibilities were expanded to include the company's Macintosh hardware engineering. From 2000 to 2002, Mr. Cook served as Senior Vice President, Worldwide Operations. Prior to joining the company, Mr. Cook was Vice President, corporate materials for Compaq Computer Corporation ("Compaq"). Prior to his work at Compaq, Mr. Cook was Chief Operating Officer of the Reseller Division at Intelligent Electronics. Mr. Cook also spent 12 years with International Business Machines Corporation ("IBM"), most recently as Director of North American Fulfillment. Mr. Cook also served as a director for NIKE, Inc. since November 2005.*[19]

The Apple Board of Directors rewarded Cook's performance in covering for Jobs in his day-to-day operations as CEO with a $5 million bonus and $52.5 million in stock options. The company's financial performance excelled during these six months.

A side effect of Jobs' latest announcement was the indefinite delay in the announcement of the launch of Rupert Murdock's iPad-only newspaper *The Daily*—which had been scheduled to take place later in January 2011 in San Francisco."[20]

A shareholder proposal for the 2011 Apple's Annual Meeting focused on asking the board for an executive succession plan and publishing the plan. The board opposed this proposal.[21] The meeting was scheduled for February 23, 2011.

On January 18, 2011, Apple announced its first quarter results, which surpassed the analysts' expected results. Key financial results are shown in the following table.[22]

	(Dollars in Thousands except per Share)	
First Quarter December 31	**2011**	**2010**
Revenue	$26,741	$15,683
Gross profit	10,298	6,471
Total operating expenses	2,471	1,686
Net income	6,004	3,378
EPS–Basic	$6.53	$3.74
EPS–Diluted	$6.43	$3.67

"We had a phenomenal holiday quarter with record Mac, iPhone, and iPad sales" said Steve Jobs, Apple CEO. "We are firing on all cylinders and we've got some exciting things in the pipeline for this year including iPhone on Verizon and consumers can't wait to get their hands on it."[23]

Corporate Governance[24]

Exhibit 4 lists the eight members of the board of directors and the executive officers as of January 26, 2010. Steve Jobs, as CEO, was the only internal board member and the only member who had served on the original board. On September 30, 2006, Fred Anderson, who had joined the board in 2004, resigned from the board over a stock options investigation. On August 28, 2006, Dr. Eric Schmidt, CEO of Google, was appointed to the board. Shaw Nu, analyst, said, "He (Schmidt) gives Jobs and Apple more perspective on dealing with Microsoft. . . . And like Jobs, Schmidt has lost at times against (Microsoft)." As soon as Schmidt's board appointment was announced, speculation began about the potential for future partnerships between Google and Apple.

On August 3, 2009, Dr. Eric Schmidt resigned from the board because Google was developing new products which would directly compete with Apple's products. In 2008, Andrea Jung became the newest member of the eight member board (see **Exhibit 4**).

Directors were eligible to receive up to two free computer systems, as well as discounts on the purchase of additional products. On the fourth anniversary of joining the board, each member was entitled to receive an option to acquire 30,000 shares of stock.

EXHIBIT 4 Apple's Board of Directors and Top Management

A. Directors

Name	Position	Age	Since
Fred A. Anderson	Director	61	2004
William V. Campbell	Co-lead Director	65	1997
Millard S. Drexler	Director	61	1999
Albert A. Gore Jr.	Director	57	2000
Steven P. Jobs	Director and CEO	50	1997
Andrea Jung	Co-lead Director	51	2008
Arthur D. Levinson, PhD	Co-lead Director	55	2000
Jerome B. York	Director	67	1997

B. Executives

Steven P. Jobs
CEO, Apple
CEO, Pixar
Director, Apple
Director, Walt Disney

Timothy D. Cook
Chief Operating Officer

Nancy R. Heinen
Senior Vice President
and General Counsel

Ron Johnson
Senior Vice President Retail

Peter Oppenheimer
Senior Vice President
Chief Financial Officer

Dr. Avdias "Avie" Tevanian Jr.
Chief Software Technology Officer

Jon Rubinstein
Senior Vice President
iPod Divison

Philip W. Schiller
Senior Vice President
Worldwide Product Marketing

Bertrand Seriet
Senior Vice President
Software Engineering

Sina Tamaddon
Senior Vice President, Applications

SOURCE: Apple Inc. *SEC DEFR 14a* (January 26, 2010), pp. 8 & 13.

Although Steve Jobs' annual salary was only $1.00 as CEO of Apple, the board gave Jobs a bonus of $84 million in 2001, consisting of $43.5 million for a private jet, a Gulfstream V; as well as $40.5 million to pay Jobs' income taxes on this bonus. Jobs owned 10,200,004 shares (1.25%) of Apple's stock. The closing price on November 8, 2010, was $318.62 per share.

Business Strategy[25]

The company was committed to bringing the best user experience to its customers through its innovative hardware, software, peripherals, services, and Internet offerings. The company's business strategy leveraged its unique ability to design and develop its own operating systems, hardware, application software, and services to provide its customers new products and solutions with superior ease-of-use, seamless integration, and innovative industrial design. The company believed continual investment in research and development was critical to the development and enhancement of innovative products and technologies. In conjunction with its strategy, the company continued to build and host a robust platform for the discovery and delivery of third-party digital content and applications through the iTunes Store. The iTunes Store included the App Store and iBookstore, which allowed customers to discover and download third-party applications and books through either a Mac or Windows-based computer or wirelessly through an iPhone, iPad, or iPod touch. The company also worked to support a community for the development of third-party software and hardware products and digital content that complemented the company's offerings. Additionally, the company's strategy included expanding its distribution to effectively reach more customers and provided them with a high-quality sales and post-sales support experience. The company was therefore uniquely positioned to offer superior and well-integrated digital lifestyle and productivity solutions.

Consumer and Small and Mid-Sized Business

The company believed a high-quality buying experience with knowledgeable salespersons who could convey the value of the company's products and services greatly enhanced its ability to attract and retain customers. The company sold many of its products and resells certain third-party products in most of its major markets directly to consumers and businesses through its retail and online stores. The company has also invested in programs to enhance reseller sales by placing high-quality Apple fixtures, merchandising materials, and other resources within selected third-party reseller locations. Through the Apple Premium Reseller Program, certain third-party resellers focused on the Apple platform by providing a high level of integration and support services, as well as product expertise.

As of September 25, 2010, the company had opened a total of 317 retail stores—233 stores in the United States and 84 stores internationally. The company typically located its stores at high-traffic locations in quality shopping malls and urban shopping districts. By operating its own stores and locating them in desirable high traffic locations, the company was better positioned to control the customer buying experience and attract new customers. The stores were designed to simplify and enhance the presentation and marketing of the company's products and related solutions. To that end, retail store configurations had evolved into various sizes to accommodate market-specific demands. The company believed providing direct contact with its targeted customers was an effective way to demonstrate the advantages of its products over those of its competitors. The stores employed experienced and knowledgeable personnel who provided product advice, service, and training. The stores offered a wide selection of third-party hardware, software, and various other accessories and peripherals that complemented the company's products.

Education

Throughout its history, the company focused on the use of technology in education and was committed to delivering tools to help educators teach and students learn. The company believed effective integration of technology into classroom instruction can result in higher levels of student achievement, especially when used to support collaboration, information access, and the expression and representation of student thoughts and ideas. The company designed a range of products, services, and programs to address the needs of education customers, including individual laptop programs and education road shows. In addition, the company supported mobile learning and real-time distribution and accessibility of education-related materials through iTunes U, which allowed students and teachers to share and distribute educational media directly through their computers and mobile communication and media devices. The company sold its products to the education market through its direct sales force, select third-party resellers, and its online and retail stores.

Enterprise, Government, and Creative

The company also sold its hardware and software products to customers in enterprise, government, and creative markets in each of its geographic segments. These markets were also important to many third-party developers who provided Mac-compatible hardware and software solutions. Customers in these markets utilized the company's products because of their high-powered computing performance and expansion capabilities, networking functionality, and seamless integration with complementary products. The company designed its high-end hardware solutions to incorporate the power, expandability, compatibility, and other features desired by these markets.

Other

In addition to consumer, SMB, education, enterprise, government, and creative markets, the company provided hardware and software products and solutions for customers in the information technology and scientific markets.

Business Organization[26]

The company managed its business primarily on a geographic basis. The company's reportable operating segments consisted of the Americas, Europe, Japan, Asia-Pacific, and Retail. The Americas, Europe, Japan, and Asia-Pacific reportable segments did not include activities related to the Retail segment. The Americas segment included both North and South America. The Europe segment included European countries, as well as the Middle East and Africa. The Asia-Pacific segment included Australia and Asia, but did not include Japan. The Retail segment operated Apple-owned retail stores in the United States and in international markets. Each reportable operating segment provided similar hardware and software products and similar services.

Each of the five operating centers is discussed below.

1. Americas

During 2010, net sales in the Americas segment increased $5.5 billion or 29% compared to 2009. This increase in net sales was driven by increased iPhone revenue, strong demand for

the iPad, continued demand for Mac desktop and portable systems, and higher sales of third-party digital content and applications from the iTunes Store. Americas Mac net sales and unit sales increased 18% and 21%, respectively, during 2010 compared to 2009, largely due to strong demand for MacBook Pro. The Americas segment represented 37% and 44% of the company's total net sales in 2010 and 2009, respectively.

During 2009, net sales in the Americas segment increased $2.4 billion or 15% compared to 2008. The increase in net sales during 2009 was attributable to the significant year-over-year increase in iPhone revenue, higher sales of third-party digital content and applications from the iTunes Store, and increased sales of Mac portable systems, partially offset by a decrease in sales of Mac desktop systems and iPods. Americas Mac net sales decreased 6% due primarily to lower average selling prices, while Mac unit sales increased by 4% on a year-over-year basis. The increase in Mac unit sales was due primarily to strong demand for the MacBook Pro. The Americas segment represented approximately 44% of the company's total net sales in both 2009 and 2008.

2. Europe

During 2010, net sales in Europe increased $6.9 billion or 58% compared to 2009. The growth in net sales was due mainly to a significant increase in iPhone revenue attributable to continued growth from existing carriers and country and carrier expansion, increased sales of Mac desktop and portable systems, and strong demand for the iPad, partially offset by a stronger U.S. dollar. Europe Mac net sales and unit sales increased 32% and 36%, respectively, during the year due to strong demand for MacBook Pro and iMac. The Europe segment represented 29% and 28% of the company's total net sales in 2010 and 2009, respectively.

During 2009, net sales in Europe increased $2.6 billion or 28% compared to 2008. The increase in net sales was due mainly to increased iPhone revenue and strong sales of Mac portable systems, offset partially by lower net sales of Mac desktop systems, iPods, and a stronger U.S. dollar. Mac unit sales increased 13% in 2009 compared to 2008, which was driven primarily by increased sales of Mac portable systems, particularly MacBook Pro, while total Mac net sales declined as a result of lower average selling prices across all Mac products. iPod net sales decreased year-over-year as a result of lower average selling prices, partially offset by increased unit sales of the higher priced iPod touch. The Europe segment represented 28% and 25% of total net sales in 2009 and 2008, respectively.

3. Japan

During 2010, Japan's net sales increased $1.7 billion or 75% compared to 2009. The primary contributors to this growth were significant year-over-year increases in iPhone revenue, strong demand for iPad, and to a lesser extent strength in the Japanese Yen. Mac net sales increased by 8% driven by a 22% increase in unit sales due primarily to strong demand for MacBook Pro and iMac, partially offset by lower average selling prices in Japan on a year-over-year basis. The Japan segment represented 6% and 5% of the company's total net sales for 2010 and 2009, respectively.

Japan's net sales increased $551 million or 32% in 2009 compared to 2008. The primary contributors to this growth were increased iPhone revenue, stronger demand for certain Mac portable systems and iPods, and strength in the Japanese Yen, partially offset by decreased sales of Mac desktop systems. Net sales and unit sales of Mac portable systems increased during 2009 compared to 2008, driven primarily by stronger demand for MacBook Pro. Net sales and unit sales of iPods increased during 2009 compared to 2008, driven by strong demand for iPod touch and iPod nano. The Japan segment represented approximately 5% of the company's total net sales in both 2009 and 2008.

4. Asia-Pacific

Net sales in Asia-Pacific increased $5.1 billion or 160% during 2010 compared to 2009. The significant growth in Asia-Pacific net sales was due mainly to increased iPhone revenue, which was primarily attributable to country and carrier expansion and continued growth from existing carriers. Asia-Pacific net sales were also favorably affected by strong demand for Mac portable and desktop systems and for the iPad. Particularly strong year-over-year growth was experienced in China, Korea, and Australia. The Asia-Pacific segment represented 13% and 7% of the company's total net sales for 2010 and 2009, respectively. Net sales in Asia-Pacific increased $493 million or 18% during 2009 compared to 2008, reflecting strong growth in sales of iPhone and Mac portable systems, offset partially by a decline in sales of iPods and Mac desktop systems, as well as a strengthening of the U.S. dollar against the Australian dollar and other Asian currencies. Mac net sales and unit sales grew in the Asia-Pacific region by 4% and 17%, respectively, due to increased sales of the MacBook Pro. The Asia-Pacific segment represented approximately 7% of the company's total net sales in both 2009 and 2008.

5. Retail

Retail net sales increased $3.1 billion or 47% during 2010 compared to 2009. The increase in net sales was driven primarily by strong demand for iPad, increased sales of Mac desktop and portable systems, and a significant year-over-year increase in iPhone revenue. Mac net sales and unit sales grew in the retail segment by 25% and 35%, respectively, during 2010. The company opened 44 new retail stores during the year, 28 of which were international stores, ending the year with 317 stores open compared to 273 stores at the end of 2009. With an average of 288 stores and 254 stores opened during 2010 and 2009, respectively, average revenue per store increased to $34.1 million in 2010, compared to $26.2 million in 2009. The Retail segment represented 15% and 16% of the company's total net sales in 2010 and 2009, respectively.

Retail net sales decreased $636 million or 9% during 2009 compared to 2008. The decline in net sales was driven largely by a decrease in net sales of iPhones, iPods, and Mac desktop systems, offset partially by strong demand for Mac portable systems. The year-over-year decline in Retail net sales was attributable to continued third-party channel expansion, particularly in the United States where most of the company's stores were located, and also reflects the challenging consumer-spending environment in 2009. The company opened 26 new retail stores during 2009, including 14 international stores, ending the year with 273 stores open. This compared to 247 stores open as of September 27, 2008. With an average of 254 stores and 211 stores opened during 2009 and 2008, respectively, average revenue per store decreased to $26.2 million for 2009 from $34.6 million in 2008.

The Retail segment reported operating income of $2.4 billion during 2010 and $1.7 billion during both 2009 and 2008. The increase in Retail operating income during 2010 compared to 2009 was attributable to higher overall net sales. Despite the decline in Retail net sales during 2009 compared to 2008, the Retail segment's operating income was flat at $1.7 billion in 2009 compared to 2008, due primarily to a higher gross margin percentage in 2009 consistent with that experienced by the overall company.

Expansion of the Retail segment has required, and will continue to require, a substantial investment in fixed assets and related infrastructure, operating lease commitments, personnel, and other operating expenses. Capital asset purchases associated with the Retail segment since its inception totaled $2.2 billion through the end of 2010. As of September 25, 2010, the Retail segment had approximately 26,500 full-time equivalent employees and had outstanding lease commitments associated with retail space and related facilities of $1.7 billion. The company would incur substantial costs if it were to close multiple retail stores, and such costs could adversely affect the company's financial condition and operating results.

Product Support and Services[27]

AppleCare® offered a range of support options for the company's customers. These options included assistance that was built into software products, printed and electronic product manuals, online support including comprehensive product information as well as technical assistance, and the AppleCare Protection Plan ("APP"). APP was a fee-based service that typically included two to three years of phone support and hardware repairs, dedicated web-based support resources, and user diagnostic tools.

Markets and Distribution[28]

The company's customers were primarily in the consumer, SMB, education, enterprise, government, and creative markets. The company utilized a variety of direct and indirect distribution channels, such as its retail stores, online stores, and direct sales force, as well as third-party cellular network carriers, wholesalers, retailers, and value-added resellers. The company believed that sales of its innovative and differentiated products were enhanced by knowledgeable salespersons who could convey the value of the hardware, software, and peripheral integration; demonstrate the unique digital lifestyle solutions that were available on its products; and demonstrate the compatibility of the Mac with the Windows platform and networks. The company further believed providing direct contact with its targeted customers was an effective way to demonstrate the advantages of its products over those of its competitors and providing a high-quality sales and after-sales support experience was critical to attracting new—and retaining existing—customers. To ensure a high-quality buying experience for its products in which service and education were emphasized, the company continued to expand and improve its distribution capabilities by expanding the number of its own retail stores worldwide. Additionally, the company invested in programs to enhance reseller sales by placing high-quality Apple fixtures, merchandising materials, and other resources within selected third-party reseller locations. Through the Apple Premium Reseller Program, certain third-party resellers focused on the Apple platform by providing a high level of integration and support services, as well as product expertise. One of the company's customers accounted for 11% of net sales in 2009; there was no single customer that accounted for more than 10% of net sales in 2010 or 2008.

Competition[29]

The company was confronted by aggressive competition in all areas of its business. The markets for the company's products and services were highly competitive. These markets were characterized by frequent product introductions and rapid technological advances that had substantially increased the capabilities and use of personal computers, mobile communication and media devices, and other digital electronic devices. The company's competitors who sold personal computers based on other operating systems had aggressively cut prices and lowered their product margins to gain or maintain market share. The company's financial condition and operating results could be adversely affected by these and other industry-wide downward pressures on gross margins. The principal competitive factors included price, product features, relative price/performance, product quality and reliability, design innovation, availability of software and peripherals, marketing and distribution capability, service and support, and corporate reputation.

The company was focused on expanding its market opportunities related to mobile communication and media devices, including iPhone and iPad. The mobile communications and

media device industries were highly competitive and included several large, well-funded, and experienced participants. The company expected competition in these industries to intensify significantly as competitors attempted to imitate some of the iPhone and iPad features and applications within their own products or, alternatively, collaborate with each other to offer solutions that were more competitive than those they currently offered. These industries were characterized by aggressive pricing practices, frequent product introductions, evolving design approaches and technologies, rapid adoption of technological and product advancements by competitors, and price sensitivity on the part of consumers and businesses.

The company's iPod and digital content services faced significant competition from other companies promoting their own digital music and content products and services, including those offering free peer-to-peer music and video services. The company believed it offered superior innovation and integration of the entire solution including the hardware (personal computer, iPhone, iPad, and iPod), software (iTunes), and distribution of digital content and applications (iTunes Store, App Store, and iBookstore). Some of the company's current and potential competitors had substantial resources and may have been able to provide such products and services at little or no profit or even at a loss to compete with the company's offerings. Alternatively, these competitors may have collaborated with each other to offer solutions that were more integrated than those they currently offered.

The company's future financial condition and operating results were substantially dependent on the company's ability to continue to develop and offer new innovative products and services in each of the markets it competed in. In 2010, only AT&T was the carrier for the iPhone. Verizon began selling a version of the iPhone in early 2011. AT&T activated 11 million iPhone accounts in the first nine months of 2010. Before Verizon, the iPhone had been exclusive to AT&T since its launch in 2007.

Supply of Components[30]

Although most components essential to the company's business were generally available from multiple sources, certain key components including but not limited to microprocessors, enclosures, certain liquid crystal displays ("LCDs"), certain optical drives, and application-specific integrated circuits ("ASICs") were currently obtained by the company from single or limited sources, which subjected the company to significant supply and pricing risks. Many of these and other key components that were available from multiple sources, including but not limited to NAND flash memory, dynamic random access memory ("DRAM"), and certain LCDs, were subject at times to industry-wide shortages and significant commodity pricing fluctuations. In addition, the company entered into certain agreements for the supply of key components including but not limited to microprocessors, NAND flash memory, DRAM, and LCDs at favorable pricing. However, there was no guarantee the company would be able to extend or renew these agreements on similar favorable terms, or at all, upon expiration or otherwise obtain favorable pricing in the future. Therefore, the company remained subject to significant risks of supply shortages and/or price increases that could materially adversely affect its financial condition and operating results.

The company and other participants in the personal computer and mobile communication and media device industries also competed for various components with other industries that experienced increased demand for their products. In addition, the company used some custom components that were not common to the rest of these industries, and introduced new products that often utilized custom components available from only one source. When a component or product used new technologies, initial capacity constraints existed until the suppliers' yields had matured or manufacturing capacity had increased. If the company's supply of a key single-sourced component for a new or existing product was delayed or constrained, if such components were available only at significantly higher prices, or if a key manufacturing

vendor delayed shipments of completed products to the company, the company's financial condition and operating results could be materially adversely affected. The company's business and financial performance could also be adversely affected depending on the time required to obtain sufficient quantities from the original source, or to identify and obtain sufficient quantities from an alternative source. Continued availability of these components at acceptable prices, or at all, may be affected if those suppliers decided to concentrate on the production of common components instead of components customized to meet the company's requirements.

Substantially all of the company's Macs, iPhones, iPads, iPods, logic boards, and other assembled products were manufactured by outsourcing partners, primarily in various parts of Asia. A significant concentration of this outsourced manufacturing was performed by only a few outsourcing partners of the company, including Hon Hai Precision Industry Co. Ltd. and Quanta Computer Inc. The company's outsourced manufacturing was often performed in single locations. Among these outsourcing partners were the sole-sourced supplier of components and manufacturing outsourcing for many of the company's key products, including but not limited to final assembly of substantially all of the company's Macs, iPhones, iPads, and iPods. Although the company worked closely with its outsourcing partners on manufacturing schedules, the company's operating results would be adversely affected if its outsourcing partners were unable to meet their production commitments. The company's purchase commitments typically covered the company's requirements for periods ranging from 30 to 150 days.

The company sources components from a number of suppliers and manufacturing vendors. The loss of supply from any of these suppliers or vendors, whether temporary or permanent, would materially adversely affect the company's business and financial condition.

Research and Development[31]

Because the industries in which the company competed were characterized by rapid technological advances, the company's ability to compete successfully was heavily dependent upon its ability to ensure a continual and timely flow of competitive products, services, and technologies to the marketplace. The company continued to develop new products and technologies and to enhance existing products that expanded the range of its product offerings and intellectual property through licensing and acquisition of third-party business and technology. Total research and development expense were $1.8 billion, $1.3 billion, and $1.1 billion in 2010, 2009, and 2008, respectively.

Patents, Trademarks, Copyrights, and Licenses[32]

The company currently held rights to patents and copyrights relating to certain aspects of its Macs; iPhone, iPad, and iPod devices; peripherals; software; and services. In addition, the company registered and/or applied to register trademarks and service marks in the United States and a number of foreign countries for "Apple," the Apple logo, "Macintosh," "Mac," "iPhone," "iPad," "iPod," "iTunes," "iTunes Store," "Apple TV," "MobileMe," and numerous other trademarks, and service marks. Although the company believed the ownership of such patents, copyrights, trademarks, and service marks was an important factor in its business and that its success depended in part on the ownership thereof, the company relied primarily on the innovative skills, technical competence, and marketing abilities of its personnel.

The company regularly filed patent applications to protect inventions arising from its research and development, and was currently pursuing thousands of patent applications around the world. Over time, the company had accumulated a portfolio of several thousand

issued patents in the United States and worldwide. In addition, the company held copyrights relating to certain aspects of its products and services. No single patent or copyright was solely responsible for protecting the company's products. The company believed the duration of the applicable patents it had been granted was adequate relative to the expected lives of its products. Due to the fast pace of innovation and product development, the company's products were often obsolete before the patents related to them expired—and sometimes were obsolete before the patents related to them were even granted.

Many of the company's products were designed to include intellectual property obtained from third parties. While it may be necessary in the future to seek or renew licenses relating to various aspects of its products and business methods, the company believed, based upon past experience and industry practice, that such licenses generally could be obtained on commercially reasonable terms; however, there was no guarantee such licenses could be obtained at all. Because of technological changes in the industries in which the company competed, current extensive patent coverage, and the rapid rate of issuance of new patents, it was possible certain components of the company's products and business methods may unknowingly infringe upon existing patents or the intellectual property rights of others. From time to time, the company had been notified that it may be infringing upon certain patents or other intellectual property rights of third parties.

Foreign and Domestic Operations and Geographic Data[33]

The United States represented the company's largest geographic marketplace. Approximately 44% of the company's net sales in 2010 came from sales to customers inside the United States. Final assembly of the company's products was performed in the company's manufacturing facility in Ireland, and by external vendors in California, Texas, the People's Republic, of China ("China"), the Czech Republic, and the Republic of Korea ("Korea"). The supply and manufacture of many critical components was performed by sole-sourced third-party vendors in the United States, China, Germany, Ireland, Israel, Japan, Korea, Malaysia, the Netherlands, the Philippines, Taiwan, Thailand, and Singapore. Sole-sourced third-party vendors in China performed final assembly of substantially all of the company's Macs, iPhones, iPads, and iPods. Margins on sales of the company's products in foreign countries, and on sales of products that include components obtained from foreign suppliers, can be adversely affected by foreign currency exchange rate fluctuations and by international trade regulations, including tariffs and antidumping penalties.

Seasonal Business[34]

The company historically experienced increased net sales in its first and fourth fiscal quarters compared to other quarters in its fiscal year due to the seasonal demand of consumer markets related to the holiday season and the beginning of the school year; however, this pattern was less pronounced following the introductions of the iPhone and iPad. This historical pattern should not be considered a reliable indicator of the company's future net sales or financial performance.

Warranty[35]

The company offered a basic limited parts and labor warranty on most of its hardware products, including Macs, iPhones, iPads, and iPods. The basic warranty period was typically one year

from the date of purchase by the original end-user. The company also offered a 90-day basic warranty for its service parts used to repair the company's hardware products. In addition, consumers may purchase the APP, which extended service coverage on many of the company's hardware products in most of its major markets.

Backlog[36]

In the company's experience, the actual amount of product backlog at any particular time was not a meaningful indication of its future business prospects. In particular, backlog often increased in anticipation of or immediately following new product introductions as dealers anticipated shortages. Backlog was often reduced once dealers and customers believed they were able to obtain sufficient supply. Because of the foregoing, backlog should not be considered a reliable indicator of the company's ability to achieve any particular level of revenue or financial performance.

Environmental Laws

Compliance with federal, state, local, and foreign laws enacted for the protection of the environment has to date had no significant effect on the company's capital expenditures, earnings, or competitive position. In the future, however, compliance with environmental laws could materially adversely affect the company.

Production and marketing of products in certain states and countries may subject the company to environmental and other regulations including, in some instances, the requirement to provide customers with the ability to return a product at the end of its useful life, as well as place responsibility for environmentally safe disposal or recycling with the company. Such laws and regulations had been passed in several jurisdictions in which the company operates including various countries within Europe and Asia and certain states and provinces within North America. Although the company did not anticipate any material adverse effects in the future based on the nature of its operations and the thrust of such laws, there was no assurance that such existing laws or future laws will not materially adversely affect the company's financial condition or operating results.

Employees

As of September 25, 2010, the company had approximately 46,600 full-time equivalent employees and an additional 2,800 full-time equivalent temporary employees and contractors.

Legal Proceedings

As of September 25, 2010, the company was subject to the various legal proceedings and claims as well as certain other legal proceedings and claims that had not been fully resolved and that had arisen in the ordinary course of business. In the opinion of management, the company did not have a potential liability related to any current legal proceeding or claim that would individually or in the aggregate materially adversely affect its financial condition or operating results. However, the results of legal proceedings could not be predicted with certainty. Should the company fail to prevail in any of these legal matters or should several of these legal matters be resolved against the company in the same reporting period, the operating results

of a particular reporting period could be materially adversely affected. The company settled certain matters during the fourth quarter of 2010 that did not individually or in the aggregate have a material impact on the company's financial condition and results of operations.

Software Development Costs

Research and development costs were expensed as incurred. Development costs of computer software to be sold, leased, or otherwise marketed were subject to capitalization beginning when a product's technological feasibility has been established and ending when a product was available for general release to customers. In most instances, the company's products were released soon after technological feasibility had been established. Therefore, costs incurred subsequent to achievement of technological feasibility were usually not significant, and generally most software development costs have been expensed as incurred.

The company did not capitalize any software development costs during 2010. In 2009 and 2008, the company capitalized $71 million and $11 million, respectively, of costs associated with the development of Mac OS X.

Properties

The company's headquarters were located in Cupertino, California. As of September 25, 2010, the company owned or leased approximately 10.6 million square feet of building space, primarily in the United States and, to a lesser extent, in Europe, Japan, Canada, and the Asia-Pacific regions. Of that amount, approximately 5.6 million square feet was leased, of which approximately 2.5 million square feet was retail building space. Additionally, the company owned a total of 480 acres of land in various locations.

As of September 25, 2010, the company owned a manufacturing facility in Cork, Ireland, that also housed a customer support call center and facilities in Elk Grove, California, that included warehousing and distribution operations and a customer support call center. In addition, the company owned facilities for research and development and corporate functions in Cupertino, California, including land for the future development of the company's second corporate campus. The company also owned a data center in Newark, California, and land in North Carolina for a new data center facility currently under construction. Outside the United States, the company owned additional facilities for various purposes.

John Tarpey's Decision

After analyzing Apple's most recent balance sheets and income statements and integrating that information with his knowledge of the company, John Tarpey was unsure of his next move. As a senior financial analyst of a securities firm, he was obligated to make a recommendation. Should he tell his clients to buy, hold, or sell Apple's common stock?

He had a number of concerns about the company's future. For example, how dependent was Apple on Steve Jobs? The shareholder proposal at the most recent shareholder meeting asking the board to develop an executive succession plan indicated that current shareholders were certainly worried about Jobs' health and ability to lead the company. In addition, how long would it take for Apple's competitors to catch up with the company's lead in product development and perhaps even surpass Apple? There was no doubt in John's mind that Apple's stock price had done very well over the past few years. Even *Mad Money's* Jim Cramer was still touting Apple as the industry's leader and "best of breed." Was this a good time to be

buying more Apple stock or was the smarter move to sell the stock and take some profit while it was still a solid performer?

Given Apple's history of boom-and-bust performance over its lifetime, what should the company be doing to cement its market leadership in this constantly evolving industry?

NOTES

1. This section was directly quoted from *Apple Inc*., "SEC 10-K," p. 22, September 25, 2010, p. 32.
2. This section, History of Apple, is a combination of information from previous revisions of the Apple Case in this book, *Strategic Management and Business Policy*, over the past 20 years, Wikipedia, the free encyclopedia, "History of Apple, Inc., pp. 1–20.
3. This section was directly quoted from "Steve Jobs," Wikipedia, the free encyclopedia, pp. 1–8.
4. Ibid., pp. 1–2.
5. Ibid.
6. "History of Apple, Inc.," pp. 2–3.
7. Previous Apple Case.
8. Pixar, "Corporate Overview," p. 1.
9. "Steve Jobs Magic Kingdom," *Business Week*, p. 3.
10. Ibid., pp. 1–5, and Vandana Sinna, "Disney, Pixar Give Marriage Second Chance," pp. 1–3.
11. "Steve Jobs Magic Kingdom," p. 1.
12. Ibid., p. 2.
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CASE 8

iRobot: Finding the Right Market Mix?

Alan N. Hoffman

iRobot Corporation, founded in 1990 in Delaware, designed and built a vast array of behavior-based robots for home, military, and industrial uses. iRobot was among the first companies to introduce robotic technology into the consumer market. Home care robots were iRobot's most successful products, with over 5 million units sold worldwide and accounting for over half of its total annual revenue. iRobot had a long-standing contractual relationship with the U.S. government to produce robots for military defense.

iRobot was fully gauged toward first mover radical innovation with an extensive R&D budget. Made up of over 500 of the most distinguished robotics professionals in the world, it aimed at leading the robotics industry. By forming alliances with companies like Boeing and Advanced Scientific Concepts, it is able to develop and improve upon products that it otherwise is incapable of obtaining using only its own technology. The company also has a healthy financial position with an excellent cash and long-term debt rate.

Despite these competencies, iRobot still had serious concerns. Although the robotics industry was not highly competitive, iRobot needed more competition to help build up the total scale and visibility of the fledgling industry it had pioneered. Home care robots, its biggest revenue source, was a luxury supplemental good. Times of economic recession could prove to

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be a problem for the sales of iRobot's consumer goods given that discretionary budgets are likely decreased. In addition, iRobot had over 70 patents, many of which will begin to expire in 2019. In a rapidly advancing industry, technology can also become obsolete quickly and render patents useless. Additionally, iRobot was highly dependent on several third-party suppliers to manufacture its consumer products. It also depends on the U.S. government for the sales of its military products. Any volatility in its supply chain or government fiscal policy has grave consequences for the company's future.

Company History

In the late 1980s, the coolest robots in the world were being developed at the MIT Artificial Intelligence Lab. These robots, modeled on insects, captured the imagination of researchers, explorers, military, and dreamers alike. iRobot cofounders, MIT professor Rodney Brooks and graduates Colin Angle and Helen Greiner, saw this technology as the basis for a whole new class of robots that could make people's lives easier and more fun. So, in 1990, the three decided to work full time on fulfilling this promise and incorporated iRobot in Delaware.[1]

After leaving the MIT extraterrestrial labs, the three entrepreneurs focused their business on extraterrestrial exploration, introducing the Genghis for robotic researchers in 1990. In 1998, the founders shifted their focus onto military tactile robots and consumer robots after landing a pivotal contract with the U.S. Defense Advanced Research Project Agency (DARPA). This contract provided the funding for necessary R&D to develop new technologies. As a direct result, iRobot delivered the PacBot to the government in 2001 to assist in the search at the NYC World Trade Center. In 2010, thousands of PacBots were serving the country on the war front.

In 2002, iRobot began selling its first practical and affordable home robot, the Roomba vacuuming robot. With millions of Roomba vacuums sold, iRobot has continued to develop and unveil new consumer robots such as a robotic gutter cleaner and pool vacuum. In 2005, iRobot raised US$120 million in its IPO and began trading on the NASDAQ stock exchange.

iRobot's Products and Distribution

iRobot designed and built robots for consumer, government, and industrial use, as shown in **Exhibit 1.** On the consumer robots front, the company offered floor cleaning robots, pool cleaning robots, gutter cleaning robots, and programmable robots. iRobot sold its home robots through a network of over 30 national retailers. Internationally, iRobot relies on a network of in-country distributors to sell these products to retail stores in their respective countries. iRobot also sold its products through its own online store and other online stores like Amazon and Wal-Mart.

Home robots have been the company's most successful products with over 5 million units sold worldwide. Sales of home robots accounted for 55.5% and 56.4% of iRobot's total revenue in 2009 and 2008, respectively.[2] Currently, iRobot is exploring new technological opportunities, including those that can automatically clean windows, showers, and toilets. The potential to fully clean one's house using automated robots is appealing to customers.

On the government and industrial robotics front, iRobot offered both ground and maritime unmanned vehicles, selling the vehicles directly to end-users or through prime contractors and distributors.[3] Its government customers included the U.S. Army, U.S. Marine Corp, U.S. Army and Marine Corps Robotic Systems Joint Program office, U.S. Navy EOD Technical Division, U.S. Air Force, and Domestic Police and First Responders. For 2009 and 2008, 36.9% and 40.3% (respectively) of iRobot total revenue came from the U.S. government.

EXHIBIT 1
iRobot Complete Product Listing

Consumer Products:

- **Roomba** floor vacuuming robot: vacuum floors and rugs at the press of a button (US$129–US$549).
- **Scooba** floor washing robot: preps, washes, scrubs, and dries hard floor surfaces (US$299–US$499).
- **Verro** pool cleaning robot: cleans a standard size pool in about an hour while removing debris as small as two microns from the pool floor, walls, and stairs (US$399–US$999).
- **Looj** gutter cleaning robot: simplifies the difficult and dangerous job of gutter cleaning (US$69–US$129).
- **Create** programmable robot: a fully assembled programmable robot based on the Roomba technology that is compatible with Roomba's rechargeable batteries, remote control, and other accessories (US$129–US$299).

Government and Industrial Products:

- iRobot 510 PackBot (advanced EOD configuration)
- iRobot 510 PackBot (FasTac configuration)
- iRobot 510 PackBot (First responder configuration)
- iRobot 510 PackBot (Engineer configuration)
- iRobot 210 Negotiator
- 310 SUGV
- iRobot 1Ka Seaglider
- iRobot 710 Warrior
- Daredevil Project
- LANdroids Project

iRobot's distribution networks were carefully monitored. "We closely manage hand-picked distributors, so that our involvement on the ground is critical as far as how to sell the product, how to help them understand the product. But their local knowledge has proven to be equally critical in finding the right sorts of distribution and handling the customers," iRobot CEO, Colin Angle, said.[4]

Competition

The robot-based products market was an emerging market with high entry barriers as it required new entrants to have access to advanced technology and large amounts of capital to invest in R&D. As a result, the market had relatively few companies competing with each other.

iRobot competed with large and small companies, government contractors, and government-sponsored laboratories and universities. It also competed with companies producing traditional push vacuum cleaners such as Dyson and Oreck.

Many of iRobot's competitors had significantly more financial resources. They include Sweden-based AB Electrolux, German-based Kärcher, South Korea-based Samsung, UK-based QinetiQ, and U.S.-based Lockheed competing against iRobot mainly in the robot vacuum cleaning market and the unmanned ground vehicle market. The iRobot product (for example, its Roomba vacuum robot) was not the most expensive but was rated the highest across the majority of the comparison points.

AB Electrolux

Founded in 1910, Electrolux was headquartered in Stockholm, Sweden. It did business in 150 countries with sales of 109 billion SEK (US$15 billion), and was engaged in the

manufacture and sales of household and professional appliances. Its Electrolux Trilobite vacuum cleaner competed with the iRobot's Roomba vacuum cleaner in the international markets. Although Electrolux Trilobite is currently unavailable in the United States it was anticipated to be sold on the company's website. An Electrolux Trilobite was priced at about US$1,800, much more than a Roomba, which retailed between US$200 and US$500.

Alfred Kärcher GmbH & Co.

Founded in 1935, Kärcher was a German manufacturer of cleaning systems and equipment, and was known for its high-pressure cleaners. Kärcher did business worldwide, with sales of €1.3 billion (US$1.7 billion). In 2003, it launched Kärcher RC 3000, the world's first autonomous cleaning system that competed with the iRobot Roomba vacuum cleaner in the international markets. Kärcher RC 3000 is not currently sold in the United States but can be purchased and shipped directly from Germany for approximately US$1,500.

Samsung Electronics Co., Ltd

Founded in 1969, Samsung was headquartered in South Korea. Samsung was the world's largest electronics company with revenue of US$117.4 billion in 2009. It was a prominent player in the world market for more than 60 products including home appliances such as washing machines, refrigerators, ovens, and vacuum cleaners. In November 2009, Samsung launched Tango, its autonomous vacuum cleaner robot, which was available in South Korea. In March 2010, the company launched the Samsung NaviBot, an autonomous vacuum cleaner, in Europe. It was priced at €400 to €600 (US$516 to US$774).

QinetiQ

Founded in 2001, QinetiQ was a defense technology company headquartered in the UK with revenues of £1.6 billion (US$2.4 billion). It produced aircraft, unmanned aerial vehicles, and energy products. iRobot's stiffest competitor in the unmanned aerial vehicles market was QinetiQ, which had 2,500 Talon robots deployed in Iraq and Afghanistan. iRobot had delivered more than 3,000 PackBot robots worldwide.

Lockheed Martin Corporation

Based in Maryland, the U.S.-based Lockheed was the world's second largest defense contractor by revenue and employed 140,000 people worldwide. It was formed by the merger of Lockheed and Martin Marietta in 1995, and competed with iRobot in the unmanned ground vehicle market.

Research and Development at iRobot

Research and development (R&D) was a critical part of iRobot's success. The company spent nearly 6% of its revenue on R&D. In 2009, its total R&D costs were US$45.5 million, of which US$14.7 million was internally funded while the remaining amount was funded by government-sponsored research and development contracts. iRobot believed that by utilizing R&D capital it would be able to respond and stay ahead of customer needs by bringing new, innovative products to the market. iRobot had 538 full-time employees, 254 of which were in R&D.[5]

The company's core technology areas were collaborative systems, semi-autonomous operations, advanced platforms, and human-robot interaction. Each area provided a unique benefit to the development and advancement of robot technology. Research in these fields was

done in three different methods: team organization, spiral development, and the leveraged model.

Team organization revolved around small teams that focused on certain specific projects or robots. They worked together with all different lines of the business to ensure that a product was well integrated. Primary locations for these teams were Bedford, Massachusetts; Durham, North Carolina; and San Luis Obispo, California.

Spiral development was used for military products. Newly creatd products were sent into the field and tested by soldiers with an in-field engineer nearby to receive feedback from the soldiers on the product's performance. Updates and improvements were made in a timely manner, and the product was sent back to the field for retesting. This method of in-field testing has allowed iRobot to quickly improve its technology and design so it can truly fulfill the needs of the end-users.

The leveraged model used other organizations for funding, research, and product development. iRobot's next generation of military products were supported by various U.S. government organizations. Although the government had certain rights to these products, iRobot did "retain ownership of patents and know-how and are generally free to develop other commercial products, including consumer and industrial products, utilizing the technologies developed during these projects."[6] The same methodology holds true when designing consumer products. If expertise was developed that would assist in governmental projects, then it is transferred to the appropriate team.

iRobot's continued success depended on its proprietary technology, intellectual skills of the employees, and the ability to innovate. The company held 71 U.S. patents, 150 pending U.S. patents, 34 international patents, and more than 108 pending foreign applications. The patents held, however, will start to expire in 2019.

Financial Results

Sales, Net Income, and Gross Margins

From 2005 through 2009, iRobot total revenue more than doubled from US$142 million to US$299 million. Revenues received from products accounted for nearly 88% of total revenue, far greater than the remaining 12% received from contract revenue, though contract revenue showed a record high of US$36 million by the end of 2009. (See **Exhibit 2**).

Revenues from 2009 showed a decline of US$9 million from 2008 that was mainly attributable to a 6.3% decrease in home robots shipped. This decrease resulted from softening demand in the domestic market. On a more positive note, the total US$30.9 million decrease in domestic sales was partially offset by an increase in international sales (US$23.2 million). Even though revenues declined in 2009, iRobot was able to control its costs and operating expenses, resulting in an increase in net income of over four-fold from US$756,000 in 2008 to US$3.3 million in 2009.

Cash and Long-Term Debt

iRobot was in a strong financial position as it related to cash and long-term debt. In 2009, iRobot increased its cash position by over US$31 million while decreasing the amount of long-term debt by about US$400,000. Its cash position by the end of 2009 was US$72 million versus US$41 million in 2010, an increase of over 77%. This put iRobot in a good position to continue investing in research and development even if sales began to slow. At the end of 2009, iRobot's long-term debt was just over US$4 million (see **Exhibit 3**). iRobot's financial status gives it a competitive edge as it should be able to withstand both current and future unforeseen swings in sales, supplier issues, and cancellation of government contracts.

EXHIBIT 2

Consolidated Statement of Operations: iRobot Corporation (Dollar amounts in thousands per share of data)

Year Ending	January 2, 2010	December 27, 2008	December 29, 2007	December 30, 2006	December 31, 2005
REVENUE					
Product revenue	$262,199	$281,187	$227,457	$167,687	$124,616
Contract revenue	36,418	26,434	21,624	21,268	17,352
Total revenue	298,617	307,621	249,081	188,955	141,968
Cost of revenue					
Cost of product revenue	176,631	190,250	147,689	103,651	81,855
Cost of contract revenue	30,790	23,900	18,805	15,569	12,534
Total cost of revenue	207,421	214,150	166,494	119,220	94,389
Gross margin	91,196	93,471	82,587	69,735	47,579
Operating expenses					
Research and development	14,747	17,566	17,082	17,025	11,601
Selling and marketing	40,902	46,866	44,894	33,969	21,796
General and administrative	30,110	28,840	20,919	18,703	12,072
Litigation and related expenses	--	--	2,341	--	--
Total operating expenses	85,759	93,272	85,236	69,697	45,469
Operating (loss) income	5,437	199	(2,649)	38	2,110
NET INCOME	$3,330	$756	$9,060	$3,565	$2,610
Net income attributable to common stockholders	$3,330	$756	$9,060	$3,565	$1,553
Net income per common share					
Basic	$0.13	$0.03	$0.37	$0.15	$0.13
Diluted	$0.13	$0.03	$0.36	$0.14	$0.11
Shares used in per common share calculations					
Basic	24,998	24,654	24,229	23,516	12,007
Diluted	25,640	25,533	25,501	25,601	14,331

Marketing

iRobot's promotion strategies varied by product group; however, neither its defense product group nor its home care product group utilized television or radio advertising. Since defense products were produced solely for the U.S. government, promotion was unnecessary. Home care products, on the other hand, needed to be marketed to generate public demand. iRobot aggressively utilized social media tools such as Facebook and Twitter primarily for promoting support services and brand recognition. For example, Facebook had at least 10 fan pages for either iRobot Corporation or selected iRobot home cleaning products like Roomba.

Another branding strategy used by iRobot education. iRobot recognized that fewer and fewer American children went into STEM (science, technology, engineering, math) areas. Therefore, it launched the SPARK (Starter Programs for the Advancement of Robotics Knowledge) program to stimulate an interest in science and technology. The program catered to students from elementary school to university. iRobot also initiated an annual National Robotics Week program to educate the public on how robotics technology impacts society. The first national robotics week was held in April 2010 in the Museum of Science in Boston.

iRobot developed an education and research robot, the Create(R) programmable mobile robot, to provide educators, students, and developers with an affordable, pre-assembled platform for hands-on programming and development. Students can learn the fundamentals of

EXHIBIT 3
Consolidated Balance Sheet: iRobot Corporation (Dollar amount in thousands)

Year Ending	January 2, 2010	December 27, 2008
ASSETS		
Current assets		
Cash and cash equivalents	$71,856	$40,852
Short-term investments	4,959	--
Accounts receivable, net of allowance of $90 and $65 at January 2, 2010, and December 27, 2008, respectively	35,171	35,930
Unbilled revenue	1,831	2,014
Inventory	32,406	34,560
Deferred tax assets	8,669	7,299
Other current assets	4,119	3,340
Total current assets	159,011	123,995
Property and equipment, net	20,230	22,929
Deferred tax assets	6,089	4,508
Other assets	14,254	12,246
Total assets	**$199,584**	**$163,678**
LIABILITIES, REDEEMABLE CONVERTIBLE PREFERRED STOCK, AND STOCKHOLDERS' EQUITY		
Current liabilities		
Accounts payable	$30,559	$19,544
Accrued expenses	14,384	10,989
Accrued compensation	13,525	6,393
Deferred revenue and customer advances	3,908	2,632
Total current liabilities	62,376	39,558
Long-term liabilities	4,014	4,444
Commitments and contingencies:		
Redeemable convertible preferred stock, 5,000,000 shares authorized zero outstanding	--	--
Common stock, $0.01 par value, 100,000,000 and 100,000,000 shares authorized and 25,091,619 and 24,810,736 shares issued and outstanding at January 2, 2010, and December 27, 2008, respectively	251	248
Additional paid-in capital	140,613	130,637
Deferred compensation	(64)	(314)
Accumulated deficit	(7,565)	(10,895)
Accumulated other comprehensive loss	(41)	--
Total stockholders' equity	133,194	119,676
Total liabilities, redeemable convertible preferred stock, and stockholders' equity	$199,584	$163,678

robotics, computer science, and engineering; program behaviors, sounds, and movements; and attach accessories like sensors, cameras, and grippers. It also ran a unique and multifaceted Educational Outreach Program that included classroom visits and tours of its company headquarters. It was designed to inspire students to choose careers in the robotics industry and become future roboticists.

Despite multiple methods of reaching out to current and potential consumers, some industry analysts claimed iRobot lacked aggressiveness toward customer acquisition. According to Mark Raskino, analyst for Gartner Research, "iRobot needs more competition, not less, to help build up the total scale and visibility of the fledgling industry it has been pioneering."[7]

Operations

iRobot was not a manufacturing company, nor did it claim to be. Its core competency was to design, develop, and market robots, not manufacture them. All non-core activities were outsourced to third parties skilled in manufacturing. While third-party manufacturers provided raw materials and labor, iRobot concentrated on developing and optimizing prototypes.

Until April 2010, iRobot used only two third-party manufacturers for its consumer products: Jetta Co. Ltd. and Kin Yat Industrial Co. Ltd., both located in China. iRobot did not have a long-term contract with either company, and the manufacturing was done on a purchase order basis. This changed in April 2010, when iRobot entered a multi-year manufacturing agreement with electronic parts maker Jabil Circuit Inc., which would make, test, and supply iRobot's consumer products, including the Roomba.[8]

The Robotic Industry

Robots serve a wide variety of industries such as consumer, automotive, military, construction, agricultural, space, renewable energy, medical, law enforcement, utilities, manufacturing, entertainment, mining, transportation, space, and warehouse industries.

In 2008, before the economic downturn, the global market for industry robot systems was estimated to be about US$19 billion.[9] Industrial robots sold worldwide in 2009 slumped by about 50% compared to 2008. The sales started to improve from the third quarter of 2009 onward with the slow recovery coming from emerging markets in Asia and especially from China. In North America and Europe, sales were also seen slowly improving from late 2009.[10]

The sales of professional services robots, including military and defense robots, were about US$11 billon at the end of 2008 and were expected to grow by US$10 billion for the period of 2009 to 2012.[11]

Twelve million units of household and entertainment robots were expected to be sold from 2009 to 2012 in the mass market, with an estimated value of US$3 billion.[12]

New Markets

The 2009 economic recession had negative impacts on consumer spending. iRobot domestic sales of robot vacuum cleaners, predominantly the Roomba, were down comparable to other US$400 discretionary purchases, and its international sales also experienced a slowdown.[13] In addition to lower consumer demand, the national and international credit crunches led to a scarcity of credit, tighter lending standards, and higher interest rates on consumer and business loans. Continued disruptions in credit markets may limit consumer credit availability and impact home robot sales.

If the robot market does not experience significant growth, the entire industry may not survive. "Fallout has forced the robotics industry to look outside of its comfort zone and move into emerging energy technologies like batteries, wind, and solar power," said Roger Christian, Vice President of Marketing and International Groups at Motoman Inc. He also predicted growing demand for robotics in healthcare and the food and beverage industry.[14] Under the Obama administration, there were economic incentives devoted to R&D in alternative energy industries. For example, "the Stimulus Act passed by Congress in early 2009, a US$787 billion package of tax cuts, state aid, and government contracts, has made some impact on the alternative energy market in favor of robotics."[15]

In addition to its home care and military markets, iRobot hoped to expand into the civil law enforcement market and the maritime market. It also explored possibilities in the

healthcare market.[16] It partnered with the toy company Hasbro to enter the toy market with My Real Baby—an evolutionary doll that has animatronics and emotional response software.

iRobot continued to grow its international presence by entering new markets. The percentage of its international sales rose from 38% in 2008 to 53.8% in 2009.[17] Its growing focus on international sales resulted in an increase of US$23.2 million in international home robots revenue for 2009 compared to 2008. iRobot also sold its military products overseas in compliance with the International Traffic in Arms Regulations.

Challenges Ahead

Consumer Marketplace

iRobot was competing in a new and emerging market. Although the industry had relatively low competition, analysts believed iRobot needed "more competition, not less, to help build up the total scale and visibility of the fledgling industry it had been pioneering."[18] If the demand for the home robots became stagnant or declined, this would greatly impact the vitality of iRobot and put it under pressure to remain innovative and adaptive to consumer needs in the event that it did gain widespread popularity.

iRobot's consumer products were primarily a luxury supplemental good gauged toward the middle and upper class. iRobot's home cleaning robots were reasonably priced from US$129 to US$1,000, depending on the model and accessories. Such a price range was comparable with luxury brands of vacuum machines. However, times of economic recession could prove to be a problem for iRobot's consumer goods sales given that discretionary budgets have contracted. To save money, iRobot's base customers may revert to manual labor.

Supply Chain

For many years, iRobot had only two China-based manufacturers to produce its home cleaning robots and had no long-term contract with either of those companies. Its best-selling Roomba 400 series and Scooba series, for example, were both produced by Jetta at a single plant in China. This put iRobot in a high-risk situation if Jetta was unable to deliver products for any unforeseen reason, or if quality started to dip below standards.

Fortunately, iRobot was aware of the problem and signed a new manufacturing agreement with U.S.-based Jabil Circuit. This relationship would provide iRobot with numerous benefits, including diversifying key elements of its supply chain, providing geographic flexibility to address new markets, and expanding overall capacity to meet growing demands, explained Jeffrey Beck, president of iRobot's Home Robots Division. Whether this attempt to diversify its supply chain with a new partnership will work out is of crucial importance for iRobot.

Intellectual Property

Although iRobot had over 70 patents and over 150 patents pending, finding ways to continue to protect this intellectual property in the long run will be a challenge. The patents iRobot holds will begin to expire in 2019. In a rapidly advancing industry, technology can also become obsolete quickly and render patents useless.

Continued development of products that were difficult to duplicate through reverse engineering will be the key to success in this area. By maintaining strong relationships and giving superior service to customers such as government agencies, iRobot can create an advantage even if they are unable to ultimately protect their technology from being duplicated. At the same time, iRobot also needs to ensure that its employees will continue to be innovative and create new technologies to keep iRobot competitive for years to come.

Government Contracts

Nearly 40% of iRobot's revenues were from government-contracted military robots. As a contractor or a subcontractor to the U.S. government, iRobot was subject to federal regulations. Fiscal policy and expenditure can be volatile, not only through a single presidency, but certainly during the transition from one presidency to the next. The volatility and unknown demand of the U.S. government presented a problem. The economic fallout from the recession also impacted U.S. federal budgetary considerations. Emphasis and focus had been placed on larger, more troubled industries, with large bailout packages made available to financial and automotive companies. It remains to be seen how these large outlays will affect the federal government's ability to continue to fund contracts for robotics.

Strategic Alliances

iRobot relied on strategic alliances to provide technology, complementary product offerings, and better and quicker access to markets. It entered an agreement with The Boeing Company to develop and market a commercial version of the SUGV that was being developed under the Army's BCTM (formerly FCS) program. It also formed an alliance with Advanced Scientific Concepts Inc. for exclusive rights to use the latter's LADAR technology of unmanned ground vehicles. In exchange, iRobot commited itself to purchase units from Advanced Scientific Concepts.

iRobot's Challenge

iRobot's focus on home cleaning products differentiates iRobot from all the other manufacturers in the robotics industry, which are mainly focused on manufacturing robots for the automotive sector. iRobot's focus on two entirely different markets—consumer and military—allowed it (1) the ability to leverage its core capabilities and diversification, and (2) provided it with a hedge against slower demand in one sector. By introducing robotics to the consumer market, iRobot created a "blue ocean of new opportunities." However, iRobot had numerous competitors with more experience in the consumer marketplace.

An analyst wondered if the long-term success in the consumer market would require iRobot to develop more "blue oceans." Also, did it make sense for iRobot to continue to develop new consumer products or would it be better off focusing on the military and aerospace marketplace?

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CASE 9

Dell Inc.: Changing the Business Model (Mini Case)

J. David Hunger

DELL INC. was founded in 1984 by Michael Dell at age 19 while he was a student living in a dormitory at the University of Texas. As a college freshman, he bought personal computers (PCs) from the excess inventory of local retailers, added features such as more memory and disk drives, and sold them out of the trunk of his car. He withdrew $1,000 in personal savings, used his car as collateral for a bank loan, hired a few friends, and placed ads in the local newspaper offering computers at 10%–15% below retail price. Soon he was selling $50,000 worth of PCs a month to local businesses. Sales during the first year reached $600,000 and doubled almost every year thereafter. After his freshman year, Dell left school to run the business full time.

Michael Dell began assembling his own computers in 1985 and marketed them through ads in computer trade publications. Two years later, his company witnessed tremendous change: It launched its first catalog, initiated a field sales force to reach large corporate accounts, went public, changed its name from PCs Limited to Dell Computer Corporation, and established its first international subsidiary in Britain. Michael Dell was selected "Entrepreneur of the Year" by *Inc.* in 1989, "Man of the Year" by *PC Magazine* in 1992, and "CEO of the Year" by *Financial World* in 1993. In 1992, the company was included for the first time among the *Fortune 500* roster of the world's largest companies.

By 1995, with sales of nearly $3.5 billion, the company was the world's leading direct marketer of personal computers and one of the top five PC vendors in the world. In 1996, Dell supplemented its direct mail and telephone sales by offering its PCs via the Internet at dell.com. By 2001, Dell ranked first in global market share and number one in the United States for shipments of standard Intel architecture servers. The company changed its name to Dell Inc.

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in 2003 as a way of reflecting the evolution of the company into a diverse supplier of technology products and services. In 2005, Dell topped *Fortune*'s list of "Most Admired Companies." Fiscal year 2005 (Dell's fiscal year ended in early February or late January of the same calendar year) was an outstanding year in which the company earned $3.6 billion in net income on $55.8 billion in net revenue.

Soon, however, increasing competition and cost pressures began to erode Dell's margins. Even though the company's net revenue continued to increase to $57.4 billion in fiscal year 2007 and $61.1 billion during fiscal year 2008, its net income dropped to $2.6 billion in 2007 with a slight increase to $2.9 billion in 2008. The "great recession" of 2008–2009 took its toll on both Dell and the computer industry. Dell's fiscal 2010 (ending January 29, 2010) net income fell further to $1.4 billion on $52.9 billion in net revenue. Sales improved during calendar year 2010 as the global economy showed signs of recovery. Net revenue for February through July 2010 increased to $30.4 billion compared to only $25.1 billion during the first half of 2009, while first half net income rose to $886 million in 2010 compared to $762 million during the same period in 2009. Nevertheless, Dell's net income was only 2.91% of net revenue during the first half of 2010 contrasted with a much rosier 6.45% during 2006. (Note: Dell's financial reports are available via the company's website at www.dell.com.)

Problems of Early Growth

The company's early rapid growth resulted in disorganization. Sales jumped from $546 million in fiscal 1991 to $3.4 billion in 1995. Growth had been pursued to the exclusion of all else, but no one seemed to know how the numbers really added up. When Michael Dell saw that the wheels were beginning to fly off his nine-year-old entrepreneurial venture, he sought older, outside management help. He temporarily slowed the corporation's growth strategy while he worked to assemble and integrate a team of experienced executives from companies like Motorola, Hewlett-Packard, and Apple.

The new executive team worked to get Dell's house in order so that the company could continue its phenomenal sales growth. Management decided in 1995 to abandon distribution of Dell's products through U.S. retail stores and return solely to direct distribution. This enabled the company to refocus Dell's efforts in areas that matched its philosophy of high emphasis on customer support and service. In July 2004, Kevin Rollins replaced Michael Dell as Chief Executive Officer, allowing the founder to focus on being Chairman of the Board. This situation did not last long, however. Rising sales coupled with rapidly falling net income caused Michael Dell to rethink his retirement and resume his role as CEO in January 2007. Although Michael Dell in 2010 owned only 11.7% of the corporation's stock, at age 45, he owned the largest block of stock and continued to be the "heart and soul" of the firm. The rest of the directors and executive officers owned less than 1% of the stock.

Business Model

Dell's original business model was very simple: Dell machines were made to order and delivered directly to the customer. The company had no distributors or retail stores. Dell PCs had consistently been listed among the best PCs on the market by *PC World* and *PC Magazine*. Cash flow was never a problem because Dell was paid by customers long before Dell paid its suppliers. The company held virtually no parts inventory. As a result, Dell made computers more quickly and cheaply than any other company.

Dell became the master of process engineering and supply chain management. It spent less on R&D than did Apple or Hewlett-Packard, but focused its spending on improving

its manufacturing process. (Dell spent 1% of sales on R&D versus the 5% typically invested by other large computer firms.) Instead of spending its money on new computer technology, Dell waited until a new technology became a standard. Michael Dell explained that soon after a technology product arrived on the market, it was a high-priced, high-margin item made differently by each company. Over time, the technology standardized—the way PCs standardized around Intel microprocessors and Microsoft operating systems. At a certain point between the development of the standard and its becoming a commodity, that technology became ripe for Dell. When the leaders were earning 40% or 50% profit margins, they were vulnerable to Dell making a profit on far smaller margins. Dell drove down costs further by perfecting its manufacturing processes and using its buying power to obtain cheaper parts. Its reduction of overhead expenses to only 9.6% of revenue meant that Dell earned nearly $1 million in revenue per employee—three times the revenue per employee at IBM and almost twice HP's rate.

Although the company outsourced some operations, such as component production and express shipping, it had its own assembly lines in the United States, Malaysia, China, Brazil, India, and Poland. A North Carolina plant had been opened in 2005 as Dell's third American desktop plant. Cost pressures had, however, caused management to rethink its manufacturing strategy. They closed the company's desktop plants in Texas and Tennessee in 2008 and 2009 respectively, and were planning to close the firm's last desktop assembly plant in North Carolina in January 2011. From then on, desktop assembly for the North American market would take place in Dell's factories in other countries and by contract manufacturers in Asia and Mexico. In Europe, the company closed its Ireland plant and sold its plant in Poland to Foxconn Technology, a unit of Hon Hai, the world's largest contract manufacturer. They then contracted with Foxconn for manufacturing services. In contrast to its global desktop manufacturing strategy, 95% of Dell's notebook computers were assembled in Dell's plants in Malaysia and China.

After its failed experiment with distribution through U.S. retail stores in the 1990s, management again changed its mind regarding its reliance on direct marketing. Over time, Dell's competitors had imitated Dell's direct marketing model, but were also successfully selling through retail outlets. A presence in retail was becoming especially important in countries outside North America. Sales in these countries were often based on the advice of sales staff, putting Dell's "direct only" business model at a disadvantage. In response, Dell began shipping its products in 2007 to major U.S. and Canadian retailers, such as Wal-Mart, Sam's Club, Staples, and Best Buy. This was soon followed by sales elsewhere in the world through DSGI, GOME, and Carrefour, among others, to number over 56,000 outlets worldwide.

Product Line and Structure

Over the years, Dell Inc. has broadened its product line to include not only desktop and laptop (listed under mobility) computers, but also servers, storage systems, printers, software, peripherals, and services, such as infrastructure services. By 2010, net revenue by product line was composed of desktop PCs (25%), mobility (31%), software and peripherals (18%), servers and networking (11%), services (11%), and storage (4%). Desktop PCs' net revenue dropped from 38% in 2006, with each of the other product lines (especially mobility) increasing as a percentage of total revenue. Although the 2010 gross margin for all Dell products was only 14.1% of sales, due to a lower average selling price, the gross margin for services, including software, was a much fatter 33.7%.

Dell's corporate headquarters was located in Round Rock, Texas, near Austin. In 2009, the company was reorganized from a geographic structure into four global business units based on

customers: *Large Enterprise*, *Public*, *Small & Medium Business*, and *Consumer*. Its 2010 revenue by segment was 27% from Large Enterprise, 27% from Public, 23% from Small & Medium Business, and 23% from the Consumer unit. Interestingly, operating income as a percentage of total revenue totaled 9% for both Public and Small & Medium Business units, 6% from Large Enterprise, and only 1% from the Consumer unit. Commercial customers accounted for 77% of total revenue. Dell was dependent upon the U.S. market for 53% of its total 2010 revenues.

The Industry Matures

By 2006, the once torrid growth in PC sales had slowed to about 5% a year. Sales fell significantly during the "great recession" of 2008–2009 as companies and consumers deferred computer purchases. With the economy improving, the output of U.S. computer manufacturers was forecast to grow at an annual compounded rate of 7% between 2010 and 2015. Nevertheless, margins were getting progressively smaller for the desktop PC, Dell's flagship product. Competitors were becoming increasingly competitive in both desktop and mobile computers.

Gateway, for example, found ways to reduce its costs and fight its way back to profitability. The same was true for Hewlett-Packard (HP) once it had digested its acquisition of Compaq. Asian manufacturers, such as Acer, Toshiba, and Lenovo, with strengths in laptops were becoming major global competitors. Ironically, by driving down supplier costs, Dell also reduced its rivals' costs. In addition, the sales growth in the computer industry was in the consumer market and in emerging countries rather than in the corporate market and developed countries in which Dell sold most of its products. Between 2006 and 2010, HP replaced Dell as the company with the largest global market share in personal computers. Using price reductions, Dell was now battling with Acer for second place in global PC market share.

As the personal computer became more like a commodity, consumers were no longer interested in paying top dollar for a computer unless it was "unique." Wal-Mart and Best Buy were selling basic laptop computers for less than $300 in 2010 and intended to maintain this pricing so long as manufacturers continued to supply low-cost products. PC notebook sales had been falling during 2010, primarily due to the introduction of Apple's highly featured iPad and the consequent rise in "tablet" PC sales. According to Morgan Stanley, Apple's iPad cannibalized about 25% of PC notebook sales since its introduction in April through August, 2010. Dell countered the iPad with a tablet computer called Streak in May 2010, but failed to generate much enthusiasm or sales for this product.

As corporate buyers increasingly purchased their computer equipment as part of a package of services to address specific problems, service-oriented rivals like IBM, HP, and Oracle had an advantage over Dell. All of these competitors had made large commitments to servers, software, and consulting—all having higher margins than personal computers. IBM had sold its laptop, hard drive, and printer businesses to focus on building its services business. Hewlett-Packard acquired Electronic Data Systems in 2008 to boost its expertise in services. By offering customers a package of servers, software, and storage, HP dominated the server business with 32% market share, with IBM closely following with 28% share of the market. Oracle's acquisition of Sun Microsystems gave it 8% of the server market. IBM and Oracle offered proprietary server platforms in enterprise accounts. In contrast, Dell (along with HP) offered x86 open-system servers. In order to better compete in the large enterprise market segment, Dell purchased Perot Systems, an IT services company, in 2009. Even after this acquisition, however, services accounted for only 13% of Dell's sales. In 2010, Dell attempted to acquire 2PAR, a data storage firm, but was outbid by HP.

Issues and Strategy

Since 2007, when Michael Dell resumed being the company's CEO, Dell has made more than 10 acquisitions, cut about 10,000 jobs, and hired executives from Motorola and Nike to add more excitement to its product line. Its $3.6 billion purchase of Perot Systems allowed it to expand into higher-margin computing services. Nevertheless, Dell's stock fell 42% since January 2007, during a period in which Hewlett-Packard's stock gained 11% and IBM gained 31%.

The industry's focus shifted from desktop PCs to mobile computing, software, and technology services—areas of relative weakness at Dell. Due to a changing industry, the company's original business model based on direct sales and value chain efficiencies had been abandoned. It was now using the same distribution channels, component providers, and assembly contractors as its competitors. Unfortunately, Dell's emphasis on cost reduction and competitive pricing meant that it was no longer perceived as providing high-quality personal computers or the quality service to go with them. Previously a strength of the company, its customer service rating in 2005 fell to a score of 74 (average for the industry) in a survey by the University of Michigan. Complaints about Dell's service more than doubled in 2005 to 1,533. Although the company successfully worked to improve customer satisfaction by adding more service people, more people meant increased costs and smaller margins.

In order to improve the company's competitive position, Dell's management initiated a three-pronged strategy:

- *Improve the core business* by profitably growing the desktop and mobile computer business and enhancing the online experience for customers. This involved cost-savings initiatives and simplifying product offerings.
- *Shift the portfolio to higher-margin and recurring revenue offerings* by expanding the customer solutions business in servers, storage, services, and software. This involved growing organically as well as through acquisitions.
- *Balance liquidity, profitability, and growth* by maintaining a strong balance sheet with sufficient liquidity to respond to the changing industry. This provided the capability to develop and acquire more capabilities in enterprise products and solutions.

Future Prospects

A number of industry analysts felt that Dell was not well positioned either for a future of low-priced, commodity-like personal computers or one of highly featured innovative digital products like the iPad and iPod. To continue as a major player in the industry, they argued that Dell needed an acquisition similar to HP's $13.2 billion purchase of EDS in order to compete in business information services. Overall, analysts were ambivalent about the firm's prospects in a changing industry. Should Dell continue with its current strategy of following the consumer market down in price and adjusting its costs accordingly or, like IBM, should it change its focus to more profitable business services, or, like HP, should it try to do both?

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CASE 10

Rosetta Stone Inc.:

CHANGING THE WAY PEOPLE LEARN LANGUAGES

Christine B. Buenafe and Joyce P. Vincelette

Introduction

ROSETTA STONE'S MISSION WAS TO CHANGE the way people learn languages. The company blended language learning with technology at a time when globalization connected more and more individuals and institutions to each other.

The potential for profit in the language-learning industry encouraged management to become more proactive and aggressive about Rosetta Stone's growth. In 2007, an industry analysis commissioned from The Nielsen Company, a market research firm, found that the language-learning industry produced over $83 billion in consumer spending.[1] Of this amount, $32 billion, or 39% of the total, was spent on self-study options. In the United States, the industry generated $5 billion in consumer spending in 2007, of which $2 billion was for self-study.[2] Over 90% of the $83 billion was spent outside the United States.

The company's debut on the New York Stock Exchange brought capital and resources that placed Rosetta Stone in an exciting and promising position. Tom Adams, President and Chief Executive Officer, said, "We are excited about hardware trends and the potential of educational technology in general. We are working in new ways with online socialization. We see our primary opportunity as growing through our own innovation. . . (W)ith added financial resources we can entertain mergers and acquisitions down the line."[3]

How should the company move forward in order to sustain its momentum? Would it be appropriate for Rosetta Stone to offer products like audio books or services such as language classrooms in order to increase market share? Which international markets would provide the company a strategic and guaranteed return? Could changes in the company's advertising and financial strategies improve Rosetta Stone's position? Should the company maintain anti-piracy initiatives

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as a priority or could its efforts be better allocated elsewhere? Companies that depend on technology face environmental risks which include economic conditions; federal, state, and local regulations; and taxes and supplier or vendor concerns.[4] To effectively compete, Rosetta Stone will have to push product and service development as well as attract and retain talented personnel.

Business Summary

Rosetta Stone Inc. provided technology-based, self-study language-learning solutions primarily under the Rosetta Stone brand. It developed, marketed, and sold software, online services, and audio practice tools to individuals, educational institutions, the armed forces, government agencies, and corporations. The company presented the language-learning market with a trusted name-brand solution that was more convenient and affordable than classroom courses, and more effective, interactive, and engaging than other self-study options.[5]

Although other programs and services claimed to teach through immersion, the company asserted that it provided the only solution that did not utilize classic teaching tools like translations, explicit grammar explanations, or extensive vocabulary lists.[6] The company believed these elements delayed and impeded achieving language proficiency. Rosetta Stone's approach sought to replicate the innate, natural language-learning ability that children use to learn their first language.[7] It referred to its teaching method as *Dynamic Immersion*.

The business model developed for Rosetta Stone distinguished the firm from other language-learning companies. The company was able to offer many languages on personal computers, on local networks, and online using its proprietary content as a result of its scalable technology platform.[8] Marketing, sales, and distribution efforts were highly integrated and focused on customer interaction with Rosetta Stone products.[9] Each marketing and distribution channel was meant to complement and support the others. This ensured greater awareness across channels, cost-effective consumer acquisition and education, premium brand building, and improved convenience for customers.[10]

The company's executive offices were in Washington, DC. It also had offices in London, Munich, Tokyo, Seoul, and Boulder, Colorado. As of December 31, 2009, the company employed 1,738 individuals: 922 full-time and 816 part-time employees.[11] Its personnel consisted of 266 employees in sales and marketing, 333 employees in research and development, 190 in general and administrative, and 894 kiosk sales employees. The company's website is www.RosettaStone.com.

History[12]

The idea for Rosetta Stone originated in the 1980s, when Allen Stoltzfus set out to learn Russian. Stoltzfus was having a difficult time with the language and he attributed his slow progress to his study methods. Years earlier, he lived and studied in Germany. His control of German was facilitated by the language immersion he experienced while abroad. To learn Russian, Stoltzfus realized that he needed to create an environment conducive to learning a language naturally, rather than sit in a classroom reviewing grammar rules and translating texts.

Stoltzfus turned to computer technology, along with contextualized inputs like pictures and conversations, to simulate the way people acquired their first language. He discussed his idea with his brother-in-law, John Fairfield, who had a PhD in Computer Science. They believed that technology was not yet ready for their ambitions.

By 1992 technology had improved. Allen Stoltzfus founded Fairfield Language Technologies in Harrisonburg, Virginia, and became the company's Chairman and President. He recruited his brother, Eugene Stoltzfus, to be Fairfield's Executive Vice President. Eugene had a background in architecture and he contributed his expertise in designing the program's appearance and organization. Allen and Eugene Stoltzfus, along with John Fairfield, named their product

Rosetta Stone, after the artifact that served as the key to understanding Egyptian hieroglyphics. Like the artifact, their product was meant to unlock language-learning success.

Allen Stoltzfus passed away in 2002 and Eugene filled the role of President and Chairman until the end of 2005. In 2003, Tom Adams was named CEO and began guiding the company's expansionary strategies. In 2005, the company opened an office in the United Kingdom.[13] In 2006, investment firms ABS Capital Partners and Northwest Equity Partners bought Fairfield Language Technologies, renaming the company Rosetta Stone.

At the end of that year, the company paid an up-front fee for a perpetual, irrevocable, and worldwide license allowing Rosetta Stone Inc. to use speech recognition technology developed at the University of Colorado.[14] The University of Colorado, Boulder, was ranked 24th and 25th on *U.S. News & World Report*'s lists of Top Speech–Language Pathology Programs and Top Audiology Programs, respectively.[15] The company also hired some of the technology's original developers to build on its speech recognition expertise. Rosetta Stone opened an office in Japan in 2007 and in Korea in 2009.[16]

The company sold its products in more than 30 different languages and in more than 150 countries when it had its initial public offering. Rosetta Stone Inc. (RST) began public trading on the New York Stock Exchange in April 2009. Its shares were priced at $18, above the estimated $15 to $17 range. The price for RST jumped 42% from $18 to $25.55 in late-morning trading.[17] Rosetta Stone sold 6.25 million shares for a total of $112.5 million. Analysts tied the company's success to a lack of publicly held competitors.[18]

In November 2009, Rosetta Stone acquired assets from SGLC International Co. Ltd., a software reseller in Seoul, South Korea. The purchase price consisted of an initial cash payment of $100,000 followed by three annual cash installment payments, based on revenue performance in South Korea.[19] Rosetta Stone's total revenue for the year ended December 31, 2009, was $252.3 million.

Corporate Governance[20]

Management Team

Tom Adams was the Chief Executive Officer of Rosetta Stone; he joined the company in 2003. In 2009, he was named the Ernst & Young Entrepreneur of the Year® overall national winner, the Executive of the Year by the American Business Awards (Stevies), and SmartCEO CEO of the Year. He was fluent in French, Swedish, English, and Spanish. He had a working knowledge of German and Chinese and was learning Russian.

Brian Helman acted as Chief Financial Officer. Prior to joining Rosetta Stone, he was CFO for NEON Systems, a publicly held provider of mainframe integration software.

Greg Keim was the head of the company's technology labs and was responsible for innovation across all products. He joined Rosetta Stone in 1992, leading technical design and development. In 1999, Keim returned to Rosetta Stone as the company's Chief Technical Officer.

Gregory Long was responsible for product development functions. He also oversaw the content team, the software development group, and the product management organization. Prior to joining Rosetta Stone, Long was Vice President of Product Development for LeapFrog SchoolHouse.

Michael Wu was responsible for all legal, corporate governance, government affairs, and compliance matters at Rosetta Stone. He joined the company in 2006 and established the firm's corporate compliance and corporate governance functions as well as its anti-piracy and anti-fraud enforcement program. He was fluent in English and Mandarin Chinese.

Mike Fulkerson led the advanced research and development group, which drove innovation for all language-learning technologies related to future products. Before joining Rosetta Stone, he was a technical director for Serco, a provider of managerial and technological consulting services.

Pamela Mulder led the international development team in charge of new market expansion and sharing best practices across markets outside the United States. Mulder joined the company in 2004 as the head of Consumer Sales and Marketing and later built up the global brand team. She was fluent in English and Spanish and was learning Italian.

Jay Topper was responsible for the Customer Success organization within Rosetta Stone, which included the support departments, language-learning coaches and the customer success team. Topper joined the Company in 2007 as Chief Information Officer.

Pete Rumpel led the company's institutional sales and marketing efforts. Before Rosetta Stone, Rumpel was Vice President and leader of SAP Americas business development. He was learning French.

Eric Duehring led global brand marketing and all United States consumer efforts including online and offline marketing, creative services, public relations, retail sales, and kiosk sales and operations. Prior to Rosetta Stone, Duehring was with AOL as senior Vice President of Marketing.

Michaela Oliver was the senior Vice President of Human Resources for Rosetta Stone. She had served as the senior Vice President of Human Resources at AOL. Oliver was conversational in Russian and French.

International Leadership

Tak Shiohama acted as President of Rosetta Stone Japan Inc., a subsidiary of Rosetta Stone Inc. Shiohama previously worked as a strategic consultant of Accenture and A.T. Kearney. He was fluent in Japanese and English and was learning Spanish, French, and Chinese.

Steven Cho was responsible for the company's business and operations in South Korea. Prior to joining Rosetta Stone, Cho was a managing partner at SGLC International. He was fluent in English and Korean and was learning French.

Sylke Riester was Managing Director of Rosetta Stone, Europe. Riester had a strong background in telecommunications and expertise in business growth. A native Dutch speaker, Riester was also fluent in German and English. She was also learning Swedish.

Oskar Handrick was the Country Manager for Germany. Handrick had worked in research and development for the BMW Group in Germany. He spoke English, French, and German fluently and was learning Spanish.

Board of Directors

Phil Clough was a managing general partner at ABS Capital Partners; his investment interests and experience included business services companies.

John Coleman was President and Chief Operating Officer of Massachusetts-based Bose Corporation until he retired in July 2005.

Laurence Franklin was the CEO of Tumi, the leading international brand of luxury travel, business, and lifestyle accessories.

Patrick Gross was Chairman of The Lovell Group, a private advisory and investment firm.

John Lindahl was a managing general partner at Norwest Equity Partners, a private equity firm.

Ted Leonsis held numerous leadership positions at AOL in his 15-year tenure, including Vice Chairman and President.

Laura Witt was a General Partner at ABS Capital Partners; her investment interests and experience included software and technology services companies.

Products and Services

As of December 31, 2009, Rosetta Stone offered the language-learning market 31 languages from which to choose. Six languages were available in up to five levels of proficiency. Nineteen languages were available in up to three levels. Six languages were available in only one level of proficiency. The company's language offerings are listed in **Exhibit 1,** which also

EXHIBIT 1
Language Offerings: Rosetta Stone Inc.

	Level 1	Level 2	Level 3	Level 4	Level 5	Audio Companion	TOTALe	Version 2	Version 3
Arabic	•	•	•			•	•		•
Chinese (Mandarin)	•	•	•			•	•		•
Danish	•							•	
Dutch	•	•	•			•	•		•
English (U.K.)	•	•	•			•	•		•
English (U.S.)	•	•	•	•	•	•	•		•
Farsi (Persian)	•	•	•			•	•		•
French	•	•	•	•	•	•	•		•
German	•	•	•	•	•	•	•		•
Greek	•	•	•			•	•		•
Hebrew	•	•	•			•	•		•
Hindi	•	•	•			•	•		•
Indonesian	•							•	
Irish	•	•	•			•	•		•
Italian	•	•	•	•	•	•	•		•
Japanese	•	•	•			•	•		•
Korean	•	•	•			•	•		•
Latin	•	•	•			•			•
Pashto	•							•	
Polish	•	•	•			•	•		•
Portuguese (Brazil)	•	•	•			•	•		•
Russian	•	•	•			•	•		•
Spanish (Latin American)	•	•	•	•	•	•	•		•
Spanish (Spain)	•	•	•	•	•	•	•		•
Swahili	•							•	
Swedish	•	•	•			•	•		•
Tagalog	•	•	•			•	•		•
Thai	•							•	
Turkish	•	•	•			•	•		•
Vietnamese	•	•	•			•	•		•
Welsh	•							•	

SOURCE: Rosetta Stone Inc., *2009 Form 10-K,* p. 10.

shows the available levels and software versions. Each level provided approximately 40 hours of the target language broken down into units, lessons, and activities.[21] Rosetta Stone offered four different editions of its language offerings: personal, enterprise, classroom, and home school. **Exhibit 2** lists the intended market for each edition and provides descriptions of any special features.

The company had Version 2 and Version 3 of its programs available at the end of fiscal year 2009. Version 2 of its software was available in 31 languages and Version 3 was available in 25 languages. The newer version of the program featured improvements in the images and audio samples used, as well as in the organization and presentation of content. Other benefits of Version 3 included: speaking activities, grammar and spelling components, simulated conversations, advanced speech recognition technology, and Adaptive Recall.[22] Adaptive Recall referred to algorithms developed by the company that had students review problem areas at longer and longer intervals, thereby improving language learners' long-term retention.[23] In July 2009, the company introduced Rosetta Stone TOTALe. These online offerings of integrated courses with coach-led practice sessions included language games, encouraged interaction with native speakers, and provided live support from customer service.[24]

The company also developed Rosetta Stone products for the exclusive use of Native American communities to help preserve their languages. Examples included: Mohawk, Chitmacha, Innutitut, and Iñupiaq.[25] In addition, the company offered a customized version of its learning solutions which focused on military-specific content for the United States Army.[26]

Customers could choose to enjoy Rosetta Stone's services on a CD-ROM or online. For the year ended December 31, 2009, the company made 87% of its revenue from CD-ROM sales and 13% from online subscriptions.[27] Customers could choose to purchase each language

EXHIBIT 2
Product Editions: Rosetta Stone Inc.

Edition	Target Market	Description
Personal	Individual consumers	Contains the core software product used for all editions. Accompanied by a compact disc audio practice tool, the *Audio Companion*. This disc contains digital audio files that can be transferred to MP3 players. The audio lessons are meant to supplement the software.
Enterprise	Businesses, armed forces, government organizations, and not-for-profit entities	Includes management tools that provide easy-to-use administrative and reporting functionality. These tools deliver easy-to-read reports and graphs that track learner activity, progress, and scores.
Classroom	Language programs in primary, secondary, and higher education settings	Designed to be incorporated into a teacher's language curriculum, complementing in-class teaching and enabling individualized self-paced learning outside the classroom. Includes a learner management tool, the *Rosetta Stone Manager*, which provides administrative and reporting functionality. This tool enables teachers to plan lessons and generate reports and graphs that track student and classroom activity, progress, and scores.
Home School	Families with home school students	Designed to provide parents the tools and resources they need to manage student progress without extensive planning or supervision. Includes administrative tools that permit parents to follow student progress and access specific information about student performance, such as completed exercises, test scores, and time spent learning, and to generate printable progress reports. Parents also have the ability to enroll their students in predefined curriculum paths designed to assist in lesson planning and in achieving learning objectives.

SOURCE: Rosetta Stone Inc., *2009 Form 10-K,* p. 9–10.

level separately or pay a discounted price by purchasing all available levels of a language together. Prices ranged from $219 for Level 1 of Indonesian to $1,199 for TOTALe Korean.

The company also supported an online peer-to-peer practice environment called SharedTalk at www.SharedTalk.com.[28] Anyone was able to register on the website for free in order to find language partners across the world and acquire pen pals for e-mail exchange. SharedTalk had more than 125,000 active users in 2009.

The company's growth strategies centered on expanding its offerings and target market. Rosetta Stone planned to develop advanced course levels and add new languages. The company also recognized that adding skill development and remediation courses to its product line could attract advanced language learners to the brand. In addition, the company could develop customized versions of its programs for industries like healthcare, business, real estate, and retail. Rosetta Stone Version 4 TOTALe was planned for release in September 2010.[29] It would integrate the Version 3 language-learning software solution with the online features of Rosetta Stone TOTALe.

Content and Curriculum[30]

Rosetta Stone's curriculum encouraged students to progress from seeing and recognizing pictures and vocabulary and hearing native speakers to actually speaking the target language. Language learners reviewed the alphabet, vocabulary, and intuitive grammar as well as the skills of reading, listening, pronunciation, and conversation without the use of translation exercises or detailed explanations. Lessons combined the introduction of new concepts, a review of recent material, and the production of key phrases. The curriculum was designed to be flexible so that learners could focus on meeting particular goals or developing certain abilities.

The company's products relied on a library of more than 25,000 photographic images and 400,000 professionally recorded sound files. The images, along with their combinations, aimed to convey a universal meaning. This enabled the company to apply the same curriculum across multiple languages and conveniently sped up the rate at which the company could add new languages to its product line. Rosetta Stone implemented a specific sequencing method devised to teach the user the most important and relevant language skills. It also incorporated languages' specific nuances, such as dual forms for parts of speech in Arabic. Any localization tailored by the company was minimal because Rosetta Stone did not rely on translations from the target language to the learner's native language.

Technology[31]

Rosetta Stone developed most of its own technology. It created content development tools that allowed curriculum specialists to write, edit, manage, and publish course materials. These tools allowed authors, translators, voicers, photographers, and editors to work efficiently and cooperatively across multiple locations. The company developed the software's intuitive user interface which assisted in the learner's transition from listening comprehension to speaking. Rosetta Stone established a student management system designed to allow teachers and administrators to configure lesson plans and to review student progress reports. The company, with the help of software firm Parature Inc., offered customer service via Facebook.[32]

The technology supporting Rosetta Stone's programs was specially designed to handle the complexities of languages. For example, the company's software was able to support languages written from right-to-left such as Arabic and Hebrew, along with languages with characters such as Chinese and Japanese. Rosetta Stone's speech recognition technology was

included in Version 3. This technology targeted the different challenges language learners encountered when speaking. For example, this technology recognized non-native speech understanding and highlighted pronunciation feedback, reinforcing correct pronunciation. The speech recognition models used by the program also included languages and dialects that had not been supported by speech recognition software in the past, such as Irish.

For the year ended December 31, 2009, the company's research and development expenses were $26.2 million, or 10.4% of total revenue. Rosetta Stone intended to advance its software platform and its speech recognition technology. The company also sought to build on its success with www.SharedTalk.com. The company was evaluating opportunities to extend its offerings to mobile technology. For example, it was developing a mobile application called Rosetta Stone Mini for release during the second half of 2010.

Manufacturing and Fulfillment[33]

Rosetta Stone focused on minimizing costs and achieving efficiency as it met its production goals. It obtained most of its products and packaging components from third-party contract manufacturers. It also had alternative sources to turn to in the event that its main manufacturers and suppliers were unavailable.

The company's fulfillment facility in Harrisonburg, Virginia, was its primary facility for packaging and distributing products. Rosetta Stone also contracted with third-party vendors in Munich for fulfillment services such as order processing, inventory control, and e-commerce; the Netherlands for consumer orders in Europe; and Tokyo, Japan, for orders in Japan.

Language-Learning Success[34]

In 2009, Rosetta Stone Inc. commissioned Roumen Vesselinov, PhD, a visiting professor at Queens College, City University of New York, as well as Rockman et al., an independent evaluation research and consulting firm, to study the effectiveness of Rosetta Stone's offerings. Their results, along with the numerous awards and recognition the company received, supported the company's initiatives and accomplishments.

Vesselinov discovered that after 55 hours of study using the company's Spanish program, a student would be able to achieve a WebCAPE score at a level sufficient to fulfill the requirements for one semester of Spanish in a college that offered six semesters of the language, with 95% confidence. WebCAPE, or the Web-based Computer Adaptive Placement Exam, was a standardized test which was used by over 500 colleges and universities for language-level placement. Sixty-four percent of the students from this study improved their oral proficiency by at least one level on a seven-level scale based on the American Council on the Teaching of Foreign Languages (ACTFL) OPIc test. This test was used worldwide by academic institutions, government agencies, and private corporations for evaluating oral language proficiency.

Rockman's study showed that after 64 hours of study with Rosetta Stone Spanish (Latin American) and six hours of Rosetta Stone Studio sessions, 78% of the students participating in its study increased their oral proficiency by at least one level on the seven-level scale developed by ACTFL. Rosetta Stone Studio provided an interactive online environment in real-time where learners communicated with students and native-speaking coaches.

In 2009, the company placed #14 on the Inc. 5000 list for the education industry. It also received the National Parenting Publications Awards (NAPPA) Honors Award for Rosetta Stone Version 3 Personal Edition, four classroom-specific awards for Classroom Version 3,

as well as two enterprise-specific awards for its products. In 2008, it received the CODiE awards for best corporate learning solution and best instructional solution in other curriculum areas from the Software & Information Industry Association. In 2007, the company won the EDDIE multilevel foreign language award for Chinese levels 1 and 2 and a multilevel English-as-a-second-language, or ESL, award for English levels 1, 2, and 3 from *ComputED Gazette*.

Marketing, Sales, and Distribution[35]

The company's growth and profitability were dependent upon the effectiveness and efficiency of Rosetta Stone's direct marketing expenditures. In 2009, 82% of Rosetta Stone's revenue was generated through the company's direct sales channels, which included its call centers, websites, institutional sales force, and kiosks.

Rosetta Stone's advertising campaigns encompassed radio, television, and print. The company had advertisements in national publications such as *Time*, *The Economist*, *The New Yorker*, and *National Geographic*. The company's strategy was to purchase "remnant" advertising segments.[36] These segments were random time slots and publication dates that had remained unsold and were offered at discounts. There was a limited supply of this type of advertising, and it was not guaranteed that the company would be able to stay within its marketing budget if these discounted slots were unavailable. Past Rosetta Stone advertisements featured U.S. Olympic gold medal swimmer Michael Phelps. Another marketing campaign depicted a farmer hoping to impress a supermodel with his Italian-speaking abilities.[37]

The company's online media advertising strategy included banner and paid search advertising, as well as affiliate relationships. Rosetta Stone worked with online agencies to buy impression-based and performance-based traffic. The company tracked the effectiveness of its advertising by asking customers to indicate the marketing campaigns that caught their attention. The company's website provided a space for users to leave testimonials and reviews. Positive stories and comments served as free word-of-mouth advertising favoring Rosetta Stone's products and services.

Marketing research supported the success of the company's advertising programs. According to an August 2008 survey commissioned from Global Market Insite Inc., a market research services firm, Rosetta Stone was the most recognized language-learning brand in the United States. Of those surveyed who had an opinion of the brand, over 80% had associated it with high quality and effective products and services for teaching foreign languages. In addition, internal studies from January and February 2009 showed that aided brand awareness for Rosetta Stone in the United States was approximately 74%–79%, based on general population surveys. Aided brand awareness refers to customers' recollection of a particular brand name after seeing or hearing about the product.

Sales and marketing expenses were 46% of total revenue for the year ended December 31, 2009.[38] That year, Rosetta Stone expanded its direct marketing activities, and sales and marketing expenses increased by $21.5 million, or by 23%, to $114.9 million. During 2009, the company increased direct advertising expenses by 25% to $42.4 million. Advertising expenses related to television and radio media and Internet marketing grew by $8.6 million. Rosetta Stone Inc. also increased its number of kiosks from 150 to 242 in 2009, which resulted in $6.2 million of additional kiosk operating expenses, which included rent and sales compensation-related expenses. Personnel costs related to growth in the institutional sales channel and marketing and sales support activities increased by $6.4 million since 2008.

The Consumer Channel[39]

Exhibit 3 provides examples of customers that represent Rosetta Stone's sales channels. For the year ended December 31, 2009, consumer sales accounted for 79% of total revenue. The consumer distribution model encompassed call centers, websites, kiosks, and select retail resellers. Language products were also offered in a limited number of ZoomShop unmanned automated kiosks. The company's growth strategy for its consumer channel involved the purchase of additional advertising services and exploration of new media channels. Rosetta Stone also intended to add retail relationships and kiosks.

The direct-to-consumer channel produced 57% of consumer revenue for the year ended December 31, 2009. This channel included sales from websites and call centers. Sales to retailers such as Amazon.com, Apple, Barnes & Noble, Books-A-Million, Borders, London Drugs retail outlets, and Office Depot accounted for 23% of consumer revenue. Sales from kiosks made up 20%.

Rosetta Stone operated 242 retail kiosks, including three full service retail outlets, in airports, malls, and other strategic high-traffic locations in 39 states and the District of Columbia. Sales associates at these kiosks promoted interest with personal demonstrations. These kiosks were considered an efficient use of retail space. Most kiosk site licenses ranged between three to six months with renewal options; the company closed underperforming kiosks.

Rosetta Stone also offered products in unmanned ZoomShop automated kiosks. ZoomShop kiosks were owned by ZoomSystems and worked like vending machines. These

EXHIBIT 3
Sales Channels: Rosetta Stone Inc.

Channel	Customer Type	Representative Customers
Consumer	Individual	According to internal studies, 60% annually earn more than $75,000 and 44% earn more than $100,000
	Retailers	Amazon.com, Apple, Barnes & Noble, Borders, Office Depot, Books-A-Million, London Drugs
Institutional	Educational institutions	Primary and Secondary Schools: New York City Department of Education (NY), DeKalb County Schools (GA), Cherokee County Board of Education (GA), Yonkers Public Schools (NY), Oakland Unified School District (CA), Manatee County Schools (FL) Universities: James Madison University, University of Wisconsin, West Chester University, Virginia Commonwealth University, Clark Atlanta University, Jackson State University
	Government, armed forces, and not-for profit organizations	U.S. Department of Homeland Security, U.S. Immigration and Customs Enforcement, Foreign Service Institute, Defense Intelligence Agency, U.S. Department of the Air Force, U.S. Army, U.S. Marines, The Church of Jesus Christ of Latter-Day Saints, Council for Adult and Experimental Learning, Pacific Training Institute Clinic, AARP, Neighborhood House of St. Paul, Seattle Goodwill
	Corporations	Reuters Group Plc, General Motors Corp., Pride International Inc., Res-Care, Inc., Cerner Corp., Tyco Electronics Corp., Molex Inc., Experian Information Solutions, Inc., Marriot International, Inc., Whole Foods Market Inc.

SOURCE: Rosetta Stone Inc., *2009 Form 10-K,* p. 13.

kiosks provided interactive demonstrations on their touch screens with audio that helped illustrate teaching techniques. These devices required low capital commitment and allowed Rosetta Stone to quickly establish a presence in retail locations. Other retailers that relied on ZoomSystems to sell their products from kiosks included Apple, Best Buy, Proactive Solution, Sephora, and the Body Shop.

The Institutional Channel[40]

For the year ended December 31, 2009, institutional sales accounted for 21% of total revenue. Rosetta Stone's institutional distribution model served four markets: primary and secondary schools, colleges, and universities; the U.S. armed forces and federal government agencies; corporations; and not-for-profit organizations.

Sales to educational institutions represented 44% of institutional sales for the year ended December 31, 2009. Sales to governmental agencies, the armed forces, and not-for-profit organizations accounted for 25% of institutional sales. Examples of not-for-profit groups purchasing Rosetta Stone products included those that trained volunteers to teach ESL students, sent members overseas for work, and established literacy programs. Home school sales represented 19% and corporations 12% of institutional revenue.

Regional sales managers were assigned to sales territories and supervised account managers who maintained the customer base. The company expanded its sales force to keep up with its institutional marketing activities. Rosetta Stone promoted interest within this channel with onsite visits, speaking engagements, trade show and conference demonstrations, seminar attendance, direct mailings, advertising in institutional publications, and responses to request-for-proposals and to calls based on recommendations from existing customers. Request-for-proposals were statements seeking certain services through a bidding process that were made to vendors.

International

International sales accounted for 8% of revenue for the year ended December 31, 2009. In addition to its international subsidiaries in the United Kingdom, Germany, South Korea, and Japan, the company operated nine kiosks in the United Kingdom, 12 in Japan, and 20 in South Korea.[41] To facilitate growth, the company planned to develop its international business through its subsidiaries and to explore opportunities in additional markets in Europe, Asia, and Latin America.

Protecting Rosetta Stone

The company relied on patents, trade secrets, trademarks, copyrights, and nondisclosure and other contractual arrangements to protect its intellectual property.[42] **Exhibit 4** lists the company's intangible assets. Rosetta Stone also protected its trade dress, or the visual appearance of its products and its packaging. The company believed that its yellow box and blue logos were important in building Rosetta Stone's brand image and distinguishing its solutions from those of its competitors.[43] In addition, individuals who worked for Rosetta Stone were required to sign agreements that prohibited the unauthorized disclosure of the company's proprietary rights, information, and technology.[44]

Each CD-ROM came with a product key that verified that the disc was not illegally copied. The key activated the program after installation and prevented multiple accesses to the

EXHIBIT 4
Intangible Assets: Rosetta Stone Inc. (Dollar amount in millions)

	December 31, 2009			December 31, 2008		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Trade name/trademark	$10,607	$ —	$10,607	$10,607	$ —	$10,607
Core technology	2,453	(2,453)	—	2,453	(2,453)	—
Customer relationships	10,842	(10,747)	95	10,739	(10,706)	33
Website	12	(10)	2	12	(7)	5
Total	$23,914	$(13,210)	$10,704	$23,811	$(13,166)	$10,645

SOURCE: Rosetta Stone Inc., *2009 Form 10-K,* p. F-20.

product. Rosetta Stone customers had to agree to terms listed in a license agreement in order to use the programs. Software could be installed on more than one personal computer, but not more than one person was allowed to use the program at the same time.[45] Those who purchased the CD-ROM were not allowed to make backup copies. Online users were forbidden to transfer their user name, password, or activation ID to any other person.

Rosetta Stone Inc. was sensitive to software piracy and how unauthorized access to its language programs affected the company's reputation and profitability. Peer-to-peer file sharing network sites like eDonkey, BitTorrent, and Direct Connect provided individuals with a means of distributing and downloading illegal copies of Rosetta Stone.[46] Unauthorized users took advantage of paid subscribers' information, using corporate or educational logins in order to access the company's online offerings. Those who disregarded Rosetta Stone's protection measures were subject to civil and criminal laws. Violators could be fined up to $250,000, face up to five years in prison, or both.[47] The company provided links on its website where individuals could report instances of piracy.

The company also attempted to educate users about the various risks they were exposed to as a result of Internet fraud.[48] On its website, Rosetta Stone explained that buying from unauthorized dealers leaves users subject to identity theft and exposed to defective or corrupted software and software viruses. In addition, using unauthorized products excluded users from access to warranties, proper manuals, support services, and software upgrades.

The Language-Learning Industry

Rosetta Stone's target customers had a number of reasons for learning a second, third, or fourth language. The language-learning industry served a replenishing global customer base. For some people, learning a language provided a means of personal enjoyment and enrichment.[49] It allowed learners to participate in new cultures and travel abroad. Many individuals also took advantage of language instruction to improve their earning power and career flexibility. In addition, people learned languages to communicate with friends and family and allow for opportunities to extend relationships past language borders. Institutions like businesses and schools especially took note of this interest in language learning in developing products, services, or advertisements in order to reach more people.

Among the most studied languages were Chinese (Mandarin), Spanish, English, and Arabic.[50] According to Simple-Chinese.com, there were 40 million people learning Chinese as a second language in 2009. This number had increased by 60% since 2004, reflecting a 10%

increase in Chinese learners every year.[51] The growth in the Spanish-speaking population in the United States influenced the popularity of the language. In 2009, the Pew Hispanic Research Center estimated that there were 44 million Hispanics living in the United States. It projected that this number would grow exponentially to over 100 million people by 2050, when Hispanics would be 25% of the total population.[52]

There were 328 million native English speakers in 2009.[53] English was the predominant language for careers in business, science, and technology. According to Asiaone.com, 33% of the world's population would be learning English by 2016.[54] British Prime Minister Gordon Brown estimated that 300 million people from China and 350 million people from India spoke English. The demand for Arabic speakers in the United States increased after the September 11, 2001, attacks and the movement of American troops into Afghanistan and Iraq.[55] Companies like Sakhr Software took advantage of this demand and their technology to market services to the U.S. government. Sakhr Software was an Egyptian company that developed a mobile application that could transmit audio translations of spoken phrases.[56]

The demand for language-learning products and services created a fragmented industry influenced by trends and consumer preferences. The industry provided language students with many alternative educational materials and environments in which to practice. Students could seek language lessons from textbook publishers, audio CD and MP3 download providers, schools and universities, language centers like Berlitz and Inlingua, and online tutoring services.[57] Students also relied on online dictionaries, translation services, and online social environments for language aid. Some services required students to pay, and others provided their offerings for free. Students could pay anywhere from $1.99 for a mobile application to $54,410 for one year of undergraduate education at Sarah Lawrence College in Bronxville, New York.[58]

Students differentiated language references and instruction by their teaching methods, effectiveness, convenience, fun and likelihood of continued practice, advertising, reputation, and price.[59] The industry took advantage of trends such as increased online accessibility and dependence, interactive games, social networking, and the use of mobile applications. According to a 2008 report by Euromonitor International Inc., a market research firm, there were more than one billion personal computers in use and 1.7 billion people using the Internet by 2009.[60] According to a 2007 report by Global Industry Analysts Inc., a market research firm, the global demand for the delivery of instructional content through the use of electronic technology, or eLearning, would grow an average of 21% annually between 2007 and 2010, reaching a total estimated value of $53 billion by 2010.[61]

Competitors

Rosetta Stone's primary competitors, most of which were privately held and divisions of larger corporations, included Berlitz International Inc., Simon & Schuster, Inc. (Pimsleur), Random House Ventures LLC (Living Language), Disney Publishing Worldwide, McGraw-Hill Education, and Pearson. These companies differentiated their products and services by means of the following features: teaching methods, effectiveness, convenience, fun and likelihood of continued practice, advertising, reputation, and price.[62]

Berlitz International Inc. presented the Berlitz Method® as a teaching style that contextualized vocabulary and grammar in real-life situations and simulated natural conversations.[63] The Berlitz School of Language was founded in 1878 and marketed to individuals, businesses, and institutions. The company had over 500 locations in 70 countries and provided access to more than 50 languages. Examples of Berlitz's offerings included online courses, study abroad

programs, and cultural consulting. Language students could participate in Berlitz's virtual semi-private instruction which started at $1,445.

Simon & Schuster, Inc. (Pimsleur) was founded in 1924.[64] It was the publishing arm of CBS Corporation, a media company. The Audio Division's Pimsleur Language Program was a series of audio books available in more than 50 languages. It was even accessible on the iPhone™ as an application. The Pimsleur Method relied on graduated interval recall, anticipation of correct responses, and utilization of core vocabulary. The program encouraged students to understand and speak from the start. Prices for Pimsleur products ranged from $11.95 to $345.

Random House Ventures LLC (Living Language) was originally developed by U.S. government experts in 1946 for overseas-bound service personnel and diplomats.[65] It offered books, CDs, digital downloads, and online courses in 28 different languages. Among its offerings were applications for the iPod or iPhone and niche references on language learning for babies and bilingual children. Prices for Living Language products ranged from $9.95 to $99.95.

Disney Publishing Worldwide was the publishing arm of Walt Disney's Consumer Products Division.[66] The company licensed its characters to English-training ventures in China until it decided to develop its own schools there for children ages 1 to 11. Disney planned to increase the number of its schools from 11 to 148 and earn over $100 million from 2010 to 2015. The company sought to reach 150,000 children whose parents were willing to pay $2,200 a year for tuition that would cover two hours of instruction per week. In China, Disney also considered initiatives such as establishing an English distance-learning program, which could involve lessons via web conferencing, e-mail, or recorded video, and developing English learning products to sell in retail outlets.

McGraw-Hill Education was a division of The McGraw-Hill Companies, founded in 1888.[67] It provided educational materials and references for the following markets: Pre-K to 12, Assessment, Higher Education, and Professional. The company had offices in 33 countries and works published in more than 65 languages. Within the language-learning industry, the company offered materials for students of all ages. Abroad, McGraw-Hill Education partnered with the Tata Group to offer English training courses tailored for the Banking/Financial Services sector.[68] In 2009, the company partnered with the Chinese vocational-training firm Ambow to launch an English-language program specifically for IT engineers.[69] The McGraw-Hill Companies had sales of $5.95 billion in 2009.

Pearson had businesses in education, business information, and consumer publishing.[70] It employed 37,000 individuals in 60 countries and provided products and services ranging from textbooks and software to assessment and teacher development materials. Pearson's English language division, Pearson Longman, provided English programs for more than 20 million students. The company also owned the Learning Education Center chain of language schools in China and developed digitally deliverable products, such as English language materials on mobile phones, for institutional and individual customers. The company made $9.1 billion in revenue fiscal year 2009.

Rosetta Stone's online competitors provided students with a myriad of language aids and opportunities to practice their skills. Some websites offered all of their services for free, while some programs charged users as their skills progressed. GermanPod101.com and ChinesePod .com offered audio and video language lessons in addition to tutoring. RhinoSpike.com, launched in March 2010, supported a library of almost 2,500 recordings spoken by native speakers.[71] Language learners frequented the site to improve their pronunciation. WordReference.com hosted forums where individuals could post and answer questions about correct phrasing and grammar.

A number of competitors took advantage of the Internet and social networking trends to help individuals feel more engaged during the learning process. Livemocha.com, a company with $14 million in venture capital financing, offered language lessons on a social network environment for more than 38 languages.[72] Users corrected each other's writing assignments and their profiles displayed points and medals won from language games. In August 2009, LiveMocha partnered with Pearson to co-develop and launch an English conversational program available on LiveMocha's online platform.[73]

MyLanguageExchange.com, founded in 2000, listed profiles of people who want to share their language expertise with others trying to learn the language.[74] MyLanguageExchange users could pay $24 per year to e-mail other users for one-on-one practice. In 2009, this website boasted 1.5 million members studying 115 languages. UsingEnglish.com, Englishcage.com, and Englishbaby.com allowed users to share photos and interests.[75] Skype, a software application that allowed users to make voice calls over the Internet, set up forums where people from around the world could practice with native speakers.

Financial Analysis

From 2004 to 2009, Rosetta Stone's revenue increased from $25.4 million to $252.3 million, representing a 58% compound annual growth rate.[76] The company's consolidated statement of operations from 2006 to 2009 is available in **Exhibit 5**. Select data from the consolidated statement of operations featuring figures from 2006 to 2009 is shown as a percent of revenue in **Exhibit 6**. Revenue from 2009 reflected an increase of $42.9 million or 21% from the amount produced in 2008. **Exhibit 7** compares revenue from 2009 to revenue from 2008. Rosetta Stone's 2008 revenue included a $2.6 million initial stocking order from Barnes & Noble to support the bookstore's expansion of Rosetta Stone products to over 650 of its national stores.[77] In 2009, Rosetta Stone did not have any comparable stocking orders. Rosetta Stone's consolidated balance sheet is available in **Exhibit 8**.

For fiscal year 2009, consumer revenue was $199.3 million, up 19% from the previous year. The company attributed this growth to a 14% increase in unit sales and a 4% increase in the average selling price of each unit.[78] The increase in sales resulted in a $23.8 million increase in revenue, and the price increase accounted for a $7.8 million increase in revenue. The increase in units sold was traced to Rosetta Stone's planned expansion of its direct marketing strategies as well as growth in its retail distribution network.[79] Product revenue represented 96% of total consumer revenue, and subscription and service revenue represented the remaining 4%.

Institutional revenue amounted to $53.0 million in 2009, increasing by $11.3 million, or 27%, since 2008. The increase in institutional revenue was primarily due to the expansion of Rosetta Stone's direct sales force.[80] This expansion increased education revenue by $4.8 million, government revenue by $3.9 million, and corporate revenue by $2.0 million. Product revenue represented 52% of total institutional revenue for the year ended December 31, 2009, and subscription and service revenue represented 48% of total institutional revenue.

According to Tom Adams, "Strong demand from both consumers and institutions for (its) industry-leading language-learning solution drove record revenues and earnings in Rosetta Stone's fourth quarter (of 2009). Rosetta Stone's consumer business delivered solid results on the back of record demand. . . ."[81] The company's international revenue accounted for 11% of fourth quarter 2009 revenue, up from 5% for the same period in 2008. It grew to $8.5 million, or 76% over the third quarter of 2009, and more than 160% over the fourth quarter of 2008.

EXHIBIT 5

Consolidated Statement of Operations: Rosetta Stone Inc. (Dollar amounts in thousands except per share amount)

Exchange Rate Used Is That of the Year End Reported Date									Jan. 4
Year Ending December 31	**2009**	**% Change**	**2008**	**% Change**	**2007**	**% Change**	**2006**	**% Change**	**2006**
Revenue									
Product	218,549	18.7	184,182	53.6	119,897	48.7	80,604	45,183.1	178
Subscription & service	33,722	33.8	25,198	44.6	17,424	62.9	10,694	11,276.6	94
Total revenue	252,271	20.5	209,380	52.5	137,321	50.4	91,298	33,465.4	272
Cost of product revenue	30,264	14.0	26,539	39.3	19,055	65.0	11,549	5,703.5	199
Cost of subscription & service revenue	3,163	48.0	2,137	30.9	1,632	64.5	992	24,700.0	4
Total cost of revenue	**33,427**	16.6	**28,676**	38.6	**20,687**	65.0	**12,541**	6,077.8	**203**
Gross profit	**218,844**	21.1	**180,704**	54.9	**116,634**	48.1	**78,757**	114,040.6	**69**
Operating expenses									
Sales & marketing expenses	114,899	23.0	93,384	42.7	65,437	42.7	45,854	6,497.7	695
Research & development*	26,239	42.7	18,387	42.6	12,893	58.8	20,714	19,697.6	41
General & administrative expenses	57,174	44.5	39,577	32.9	29,786	79.5	16,590	11,583.1	142
Lease abandonment	-	-	1,831	-	-	-	-	-	-
Total operating expenses	**198,312**	29.5	**153,179**	41.7	**108,116**	30.0	**83,158**	-	
Other income and expense									
Interest income	159	(65.0)	454	(32.5)	673	9.8	613	-	-
Interest expense	356	(60.0)	891	(33.1)	1,331	(14.7)	1,560	-	-
Other income	112	(53.1)	239	55.2	154	156.7	60	1,900.0	3
Total other income (expense)	**(85)**	(57.1)	**(198)**	(60.7)	**(504)**	(43.2)	**(887)**	(29,666.7)	**3**
Income (loss) before income taxes	20,447	(25.2)	27,327	241.0	8,014	(251.6)	(5,288)	(52.5)	(11,121)
Income tax provision (benefit)	7,084	(47.3)	13,435	147.2	5,435	(538.3)	(1,240)	-	-
Net income (loss)	**13,363**	(3.8)	**13,892**	438.7	**2,579**	(163.7)	**(4,048)**	(63.6)	**(11,121)**
Preferred stock accretion	-	-	-	-	80	(49.7)	159	-	-
Net income (loss) attributable to common stockholders	**13,363**	(3.8)	**13,892**	455.9	**2,499**	(159.4)	**(4,207)**	(62.2)	**(11,121)**
Year end shares outstanding	20,440	955.8	1,936	5.4	1,837	14.0	1,612	-	-
Net earnings (loss) per share—basic	**1**	(87.8)	**7**	395.9	**1**	(155.9)	**(3)**	(979.6)	**0**
Net earnings (loss) per share—diluted	**1**	(18.3)	**1**	446.7	**0**	(105.7)	**(3)**	(979.6)	**0**
Weighted average shares outstanding—basic	**14,990**	686.9	**1,905**	11.9	**1,702**	6.5	**1,598**	(104.3)	**(37,194)**
Weighted average shares outstanding—diluted	**19,930**	17.8	**16,924**	2.4	**16,533**	934.6	**1,598**	(104.3)	**(37,194)**

*In 2006, Research and Development expenses included $12,597 of acquired in-process R&D.

SOURCE: Rosetta Stone Inc., *2009 Form 10-K,* p. F-4.

EXHIBIT 6

Consolidated Statement of Operations: Rosetta Stone Inc. (Dollar amount in thousands except per share amounts)

As a Percent of Total Revenue
Exchange Rate Used Is That of the Year End Reported Date

	Year Ended December 31,								January 4,	
Year Ending December 31	2009	% of Revenue	2008	% of Revenue	2007	% of Revenue	2006	% of Revenue	2006	% of Revenue
Revenue										
Product	218,549	86.6	184,182	88.0	119,897	87.3	80,604	88.3	178	65.4
Subscription & service	33,722	13.4	25,198	12.0	17,424	12.7	10,694	11.7	94	34.6
Total revenue	252,271		209,380		137,321		91,298		272	
Cost of product revenue	30,264		26,539		19,055		11,549		199	
Cost of subscription & service revenue	3,163		2,137		1,632		992		4	
Total cost of revenue	**33,427**		**28,676**		**20,687**		**12,541**		**203**	
Gross profit	**218,844**		**180,704**		**116,634**		**78,757**		**69**	
Operating expenses										
Sales & marketing expenses	114,899	45.5	93,384	44.6	65,437	47.7	45,854	50.2	695	255.5
Research & development*	26,239	10.4	18,387	8.8	12,893	9.4	20,714	8.9	41	15.1
General & administrative expenses	57,174	22.7	39,577	18.9	29,786	21.7	16,590	18.2	142	52.2
Lease abandonment	-	-	1,831.0	0.9	-	-	-	-	-	-
Total operating expenses	**198,312**	78.6	**153,179**	73.2	**108,116**	78.7	**83,158**	91.1	**878**	322.8

*In 2006, Research and Development expenses included $12,597 of acquired in-process R&D.

SOURCE: Rosetta Stone Inc., *2009 Form 10-K,* p. F-4.

EXHIBIT 7

Revenue Comparison for 2009 and 2008: Rosetta Stone Inc.

	Year Ended December 31					
	2009		2008		Change	% Change
	(dollars in thousands)					
Product revenue	$218,549	86.6%	$184,182	88.0%	$34,367	18.7%
Subscription and service revenue	33,722	13.4%	25,198	12.0%	$8,524	33.8%
Total revenue	$252,271	100.0%	$209,380	100.0%	$42,891	20.5%
Revenue by sales channel						
Direct-to-consumer	$114,002	45.2%	$96,702	46.2%	$17,300	17.9%
Kiosk	40,418	16.0%	36,314	17.3%	$4,104	11.3%
Retail	44,850	17.8%	34,638	16.5%	$10,212	29.5%
Total consumer	199,270	79.0%	167,654	80.1%	31,616	18.9%
Institutional	53,001	21.0%	41,726	19.9%	$11,275	27.0%
Total revenue	$252,271	100.0%	$209,380	100.0%	$42,891	20.5%

SOURCE: Rosetta Stone Inc., *2009 Form 10-K,* p. 53.

EXHIBIT 8

Consolidated Balance Sheet: Rosetta Stone Inc. (in thousands, except per share amounts)

Exchange Rate Used Is That of the Year End Reported Date Year Ending December 31	2009	% Change	2008	% Change	2007
ASSETS					
Current assets					
Cash & cash equivalents	95,188	210.8	30,626	41.2	21,691
Restricted cash	50	47.1	34	(91.3)	393
Accounts receivable, net	37,400	41.1	26,497	123.6	11,852
Inventory, net	8,984	82.9	4,912	27.2	3,861
Prepaid expenses & other current assets	7,447	12.9	6,598	70.4	3,872
Deferred income taxes	6,020	163.8	2,282	169.1	848
Total current assets	**155,089**	118.6	**70,949**	66.9	**42,517**
Property & equipment, net	18,374	16.8	15,727	17.0	13,445
Goodwill	34,838	1.9	34,199	0.0	34,199
Intangible assets, net	10,704	0.6	10,645	(22.1)	13,661
Deferred income taxes	5,565	(18.5)	6,828	12.2	6,085
Other assets	872	85.5	470	0.2	469
Total assets	**225,442**	62.4	**138,818**	25.8	**110,376**
LIABILITIES					
Current liabilities					
Accounts payable	1,605	(50.0)	3,207	(30.8)	4,636
Accrued compensation	10,463	22.1	8,570	73.5	4,940
Other current liabilities	25,638	20.1	21,353	87.0	11,421
Deferred revenues	24,291	68.9	14,382	19.4	12,045
Income taxes payable	4,184	-	-	-	-
Current maturities of long-term debt—related party	-	-	4,250	25.0	3,400
Total current liabilities	**66,181**	27.9	**51,762**	42.0	**36,442**
Long-term debt, related party	-	-	5,660	(42.9)	9,909
Deferred revenue	1,815	33.3	1,362	52.3	894
Other long-term liabilities	1,011	5.0	963	15,950.0	6
Total liabilities	**69,007**	15.5	**59,747**	26.4	**47,251**
STOCKHOLDERS' EQUITY					
Class B redeemable convertible preferred stock	-	-	-	-	5,000
Class A, series A-1 convertible preferred stock	-	-	26,876	0.0	26,876
Class A, series A-2 convertible preferred stock	-	-	17,820	0.0	17,820
Class B convertible preferred stock	-	-	11,341	78.9	6,341
Common stock, net	2	100.0	1	0.0	1
Additional paid-in capital	130,872	1,110.2	10,814	25.6	8,613
Accumulated income (loss)	25,785	107.6	12,422	(945.0)	(1,470)
Accumulated other comprehensive income (loss)	(224)	10.3	(203)	262.5	(56)
Total stockholders' equity (deficit)	**156,435**	97.8	**79,071**	36.0	**63,125**
Total liabilities and stockholders' equity	**225,442**	62.4	**138,818**	31.7	**110,376**

SOURCE: Rosetta Stone Inc., *2009 Form 10-K,* p. F-3.

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CASE 11

Logitech (Mini Case)

Alan N. Hoffman

Company Background

LOGITECH, HEADQUARTERED IN ROMANEL-SUR-MORGES, SWITZERLAND, was the world's leading provider of computer peripherals in 2010. Personal computer peripherals were input and interface devices that were used for navigation, Internet communications, digital music, home-entertainment control, gaming, and wireless devices. Derived from the French word *logiciel*, meaning software, Logitech was originally established as a software development and hardware architecture company by two Stanford graduate students in Apples, Switzerland. Shortly after establishing itself as a quality software development company, Logitech saw a new hardware product opportunity that was emerging in the mid 1980s, the computer mouse. The mouse was standard equipment on the original Macintosh computer launched in January 1984. Logitech viewed the mouse as a growth opportunity and it became a turning point for the company's future. Logitech introduced its first hardware device, the P4 mouse, for users of graphics software. An OEM sales contract with HP followed, and in 1985 it entered the retail market, selling 800 units in the first month.

In July of 1988, Logitech's executives decided to take the company public to help finance its rapid growth. Then, in the early 1990s, while facing increasingly strong competition in the mouse business, Logitech identified a larger market opportunity for computer peripherals and began growing its business beyond the mouse. In the next few years, Logitech introduced products such as (1) computer keyboards, (2) a digital still camera, (3) a headphone/microphone, (4) a joystick gaming peripheral, and (5) a web camera on a flexible arm. While these new products were being introduced under the Logitech name, the company also continued innovation in its core mouse

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business. New and revolutionary technologies that were being developed by Logitech allowed it to continue to be an industry leader in the mouse and keyboard business.

In the mid-1990s, the PC market exploded due to the popularity of the Internet and new home/office software applications. This growth of the PC industry created demand for the peripheral products that Logitech produced. The Internet allowed computer users to access new areas such as music, video, communications, and gaming. From this point forward, Logitech continued to grow both organically and through acquisition as new opportunities arose to expand its portfolio of products.

Between 1998 and 2006, Logitech made a number of significant acquisitions to expand its product portfolio. It acquired companies such as Connectix for its line of webcams, Labtec for its audio business presence, Intrigue Technologies for its "Harmony" remote controls, and Slim Devices for its music systems. All of these acquisitions were done strategically to help Logitech position itself in all aspects of the personal computer peripherals world.

In addition to growing significantly through strategic acquisitions, Logitech also continued to innovate and grow its core business. Logitech made significant innovations in the area of cordless mice and keyboards. It also introduced the industry's first retail pointing device with Bluetooth wireless technology. Logitech then expanded its Bluetooth technology to many other products in the digital world such as cordless gaming controllers and a personal digital pen.

Logitech provided consumers with cutting-edge innovation while maintaining its product quality. Logitech maintained its product leadership by combining continued innovation, award-winning industrial design, and excellent price performance with core technologies such as wireless, media-rich communications and digital entertainment.

Competitors

Within the specialized personal peripherals industry, Logitech had three major competitors: Creative Technology Ltd., Microsoft Corporation, and Royal Philips Electronics N.V.

Creative Technology Ltd. was one of the worldwide leaders in digital entertainment products for the personal computer (PC) and the Internet. Creative Technology was founded in Singapore in 1981, with the vision that multimedia would revolutionize the way people interact with their PCs. The product line offered by Creative Technology included MP3 players, portable media centers, multimedia speakers and headphones, digital and web cameras, graphics solutions, revolutionary music keyboards, and PC peripherals. Creative had a net profit margin of (−29.58%) in FY 2009 and (−32.82%) in the first quarter of 2010.

Microsoft Corporation provided software and hardware products and solutions worldwide. Founded in 1975 by Bill Gates and Paul Allen, Microsoft's core business was to create operating systems and computer software applications. Microsoft expanded into markets such as mice, keyboards, video game consoles, customer relationship management applications, server and storage software, and digital music players. In FY 2009, Microsoft Corporation had annual sales of $58.4 billion and a net income of $14.5 billion.

Royal Philips Electronics was a Netherlands-based company that focused on improving people's lives through innovation. Philips was a well-diversified company with products in many different businesses: consumer electronics, televisions, VCRs, DVD players, and fax machines, as well as light bulbs, electric shavers and other personal care appliances, medical systems, and silicon systems solutions. With this diversified portfolio of products, Royal Philips had FY 2009 revenues of $30.76 billion and a gross profit of $11.59 billion.

Logitech was the only company exclusively focused on personal computer peripheral products, whereas all of its competitors had products and resources invested in a variety of other industries as well.

Trends

Logitech implemented a strategy of innovation, mixed with strategic acquisitions, to enhance its products with the technologies and software of other companies in order to create the most advanced, safest, and most innovative and collaborative experience for its customers. As Logitech had always been on the forefront of mouse and keyboard technology, it had also been a leader in video conferencing technology since the early stages of the Logitech mountable computer camera.

From 1998–2004, Logitech made many important strategic acquisitions in order to enhance future portfolios and expand the depth of the peripheral product lines. Its first acquisition was the video camera division, QuickCam PC, of Connectix Corporation. This led to an influx of peripherals such as cameras and wireless cameras, and served as a very early introduction to the current video conferencing division of Logitech. The second successful acquisition for Logitech was Labtec Inc., an audio peripheral maker, in 2001. Following this acquisition, with a hunger to expand product focus, Logitech acquired Intrigue Technologies Inc. in 2004. This acquisition positioned Logitech as a leader in advanced remote control-making, allowing peripherals to accommodate more than just computer and video game uses. This positioned it for its next acquisition—Slim Devices, a manufacturer of music systems—in 2006. Logitech used these acquisitions to expand its multibusiness unit corporation into a diverse and specialized company appealing to a large group of technology users. Finally, with its acquisition of Paradial AS, Logitech was able to combine its peripheral products with the software, video effects, and security features of Paradial. This allowed Logitech to deliver a complete and intuitive HD video conferencing experience for companies of any size.

Future industry trends revolved around content strategy and consumer expectations of the mobile web and smartphone applications. Content strategy involved the decisions about what information/features to include in a product, including those that provided the most benefit or fulfill the most needs; anything else was just noise and diluted the product. In terms of the mobile web and smartphone application trends, Logitech had three options: (1) develop closed partnerships with specific platforms (iPhone or Blackberry); (2) produce apps (applications) for each platform; or (3) produce "platform-neutral" apps by using the mobile web.

Global Presence

As the global economy has expanded and become more reliant on technology, Logitech has seen an increase in the desire for ease of use when it comes to portable computers, games, and video conferencing technology. Logitech has consistently expanded its product offerings to satisfy this growing demand for computer peripherals. In FY 2009, 85% of its revenue came from retail sales of peripheral products such as mice, keyboards, speakers, webcams, headsets, headphones, and notebook stands. Logitech has also seen global demand sharpen for devices designed for specific purposes such as gaming, digital music, multimedia, audio and visual communication over the Internet, and PC-based video security. The company's products combined essential core technologies, continued innovation, award-winning industrial design, and excellent value that were necessary to come out on top of a rapidly changing and evolving technological industry. Since its inception in 1981 in Apples, Switzerland, Logitech has been a growing player in the technological product market and distributed products to over 100 different countries.

For Logitech, opportunities arose as the desire for global communication has risen. The trend of wireless and portable communication, such as Skype and Apple's Facetime, has opened up a window of opportunity for new and more advanced products to enable video communication and conferencing.

As computers age, Logitech has been able to sell add-on peripherals to users that want to add newer applications to their older computers. Logitech has been able to sell products at the end of the product life cycle such as mice and keyboards and generate profits to fund new product development such as the new Logitech Revue with Google TV. As its consumers became more globally conscious and connected, Logitech was able to tailor its products toward the many uses of video communication and high speed Internet capabilities.

Logitech created a global presence and reputation for its brand and products. In 2009, Logitech's sales were distributed globally with 45.3% in the Eastern Europe, Middle East, and North Africa regions; 35.6% in the Americas; and 19.1% in Asia Pacific. By expanding its presence globally, Logitech became the leading provider of personal peripherals in the world. In addition to being an innovator in its industry, Logitech has also maintained reasonably priced products as well. In 2009, 67% of its sales stemmed from products that were priced less than $60. This innovative mindset, in addition to reasonable prices, has also contributed to large sales and, in the end, Logitech's good financial health as a company.

Finance

The recession in 2008–2009 hit hard on Logitech's business: for the full fiscal year 2010, sales were $2.0 billion, down from $2.2 billion in fiscal 2009. Operating income was $78 million, down from $110 million the previous year. Net income was $65 million ($0.36 per share), compared to $107 million ($0.59 per share) in the prior year. Gross margin for fiscal 2010 was 31.9% compared to 31.3% in fiscal 2009. As a result of the economic downturn, Logitech found it necessary to restructure its workforce. In early 2009 Logitech reduced its salaried workforce globally by 15%.

Logitech's stock price spiked to $40 in late 2007, as a result of record sales and profits from its successful launch of iPod-capable peripherals. Its iPod peripherals—speakers, docks, and headphones—made the increasingly popular iPod easier to use.

In 2009, Logitech's operating margin was 5.15%, far below its 2007 high of 12% due to increasing price competition.

Logitech did not issue dividends to shareholders so that it could reinvest its net income back into research and development and product advertising, as well as have it available for strategic acquisitions, causing a continuous cycle.

Logitech outlined specific financial objectives that it sought to achieve. It wanted to achieve sales growth between 13%–19% and a gross margin between 32%–34%. Logitech also intended to invest 5% of its sales revenue in R&D and 12%–14% in marketing. By continuously investing resources in research and development, Logitech took a strategic approach to maintaining long-term growth and profitability.

Operations

One of the initial weaknesses that Logitech faced regarding operations was that it had numerous manufacturing locations dispersed throughout the world. The problem with having so many locations was that these facilities were not cost effective. Many of its plants were located in countries where it was expensive to operate and the labor costs for qualified employees was high. Logitech saw that, in the early 1990s, the personal computer industry was becoming increasingly competitive. Having recognized this, Logitech made two primary operations decisions that allowed it to increase its competitiveness. First, Logitech consolidated manufacturing, which was once widely dispersed in China. This allowed the company to

maintain lower prices on its products and increase its competitiveness. In addition to its China manufacturing facilities, Logitech established a second center for R&D, located in Cork, Ireland, a prime location for innovation in the technology and IT sectors. This resolved the issue of Logitech having several expensive locations by moving into fewer, more cost effective facilities. In addition to moving manufacturing, Logitech also knew its category was changing and that it would no longer be able to compete by only manufacturing computer mice. Therefore, Logitech expanded its product line beyond the mouse and introduced a variety of products including a handheld scanner, Fotoman (a digital camera), Audioman (a speaker/microphone), and Wingman (the first gaming peripheral).

These operational decisions not only helped Logitech remain innovative and competitive within the industry, but also positioned it for success during the personal computing industry boom in the mid- to late 1990s, when the Internet and online industries took off. Logitech, known as a leading personal peripheral provider, was both innovative, with more than 130 personal computer peripheral products, and reasonably priced. When the PC industry took off, Logitech was already established as an industry leader and its sales soared.

Logitech was also a leader in the wireless peripherals sector. By following consumer trends, Logitech saw the personal peripherals sector was moving into a new digital era, where wireless peripherals was a new trend. Logitech created an entirely new product category with the Logitech Cordless Desktop, a wireless mouse and keyboard bundle. By staying on top of consumer trends, Logitech sold over 100 million cordless mice and keyboards.

The Changing Landscape Ahead

Logitech became a leader in computer peripherals by developing innovative products and focusing on the consumer's experience. Between 2007 and 2010 alone, Logitech received 11 different awards for 19 products in 14 categories. In a market that was saturated with deep-pocketed competitors such as Microsoft and Philips, Logitech used innovation as its means of survival.

In 2010, Logitech faced a significant challenge in that the way that people interacted with its devices was changing. The iPhone and iPad used touch-screen technology with built-in accelerometers, eliminating the need for mice and trackpads. Secondly, cameras and higher quality speakers became standard equipment built into the iPhone, iPad, and Windows laptop computers. Apple introduced the "magic pad" to replace the mouse altogether. The need for consumers to buy add-on peripherals was slowly evaporating as more of the peripherals became standard equipment designed into new mobile technologies.

Logitech could see its peripherals market someday disintegrate before its own eyes. Logitech needed to decide if it should invest more in video conferencing and television all-in-one remote controls and/or focus on developing partnerships with computer and telecom manufacturers and mobile carriers such as AT&T, Verizon, T-Mobile, and Sprint. Once again, the computer industry was changing and Logitech needed to formulate diversification strategies to ensure its long-term survival.

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CASE 12

Google Inc. (2010): The Future of the Internet Search Engine

Patricia A. Ryan

Google began with a mission: to create the ultimate search engine to help users tame the unruly and exponentially growing repository of information that is the Internet. And most would agree that when the word "Google" became a verb, that mission was largely accomplished.[1]

IT HAD BEEN NEARLY SIX YEARS SINCE GOOGLE'S ATTENTION-grabbing initial public offering and, despite overall stock market weakness, Google remained strong. Although the stock moved with the market in general, the company returned significantly higher returns to its shareholders than did the S&P 500 (**Exhibit 1**). Founders Sergey Brin and Larry Page had created a huge empire in which they now faced challenges of continued growth and innovation. These challenges would carry them through the second decade of the new millennium.

Background[2]

Google was founded in a garage in 1998 by Larry Page and Sergey Brin, two Stanford computer science graduate students, based on ideas generated in 1995. The name *Google* was chosen as a play on *googol*, a mathematical term for the number one followed by one hundred zeros. It is thought the term was appealing to the founders as it related to their mission to organize an exponentially growing web. Founded on $100,000 from Sun Microsystems, Brin and Page were on their way to creating an Internet engine giant. Google immediately gained the attention of the Internet sector for being a better search engine than its competitors, including Yahoo!

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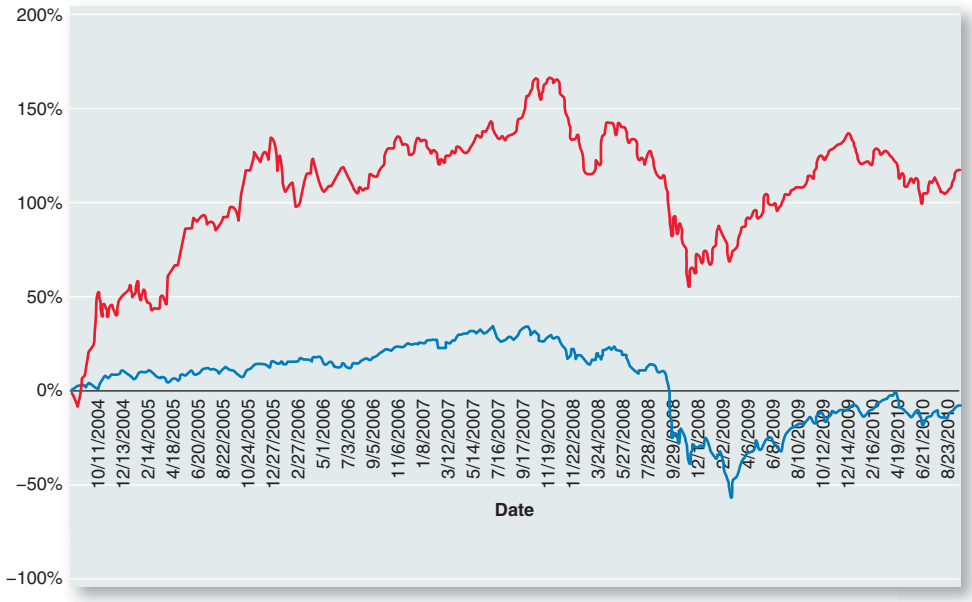
EXHIBIT 1
Cumulative Returns on Google (red line) vs. S&P 500 (blue line) (2004–2010)



By 2000, Google was in 15 languages and gaining international acclaim for its web search services. The Google toolbar was first released in late 2000. Current Chairman of the Board Eric Schmidt joined Google in that capacity in March 2001. In 2002, Google released Adwords, which was a new cost per click pricing system for advertising.

In August 2004, Google went public with 19,605,042 shares at an opening price of $83 per share. **Exhibit 1** traces the growth of Google stock to over $600 per share at the end of 2009. Gmail, an instant messaging and free e-mail service, was released in 2006, just a few months before the announced acquisition of YouTube. In that announcement, CEO Eric Schmidt stated:

> *The YouTube team has built an exciting and powerful media platform that compliments Google's mission to organize the world's information and make it universally accessible and useful. Our companies share similar values; we both always put our users first and are committed to innovating to improve their experience. Together, we are natural partners to offer a compelling media entertainment service to users, content owners, and advertisers.*[3]

DoubleClick was acquired in 2008. In 2009, Google Docs was introduced. It allowed a user to upload all file types, including ZIP files, in order to work with those files online. The company moved into public education, starting in Oregon with Google Apps for Education. Regarding the transformation of technology in education, Jeff Keltner, a senior manager at Google who worked with educational institutions to increase the use of Google's technology in higher education, commented, "We don't know what the future classrooms will look like. We want to work with schools in a continual evolution to discover what it could look like."[4] The use of Google Docs and Google Spreadsheets in team projects provided the opportunity for increased technological application in the classroom in a manner that business professors had not had the opportunity to apply in the past. Keltner stated that he did not see the biggest challenges as technology-based, but rather culture-based, in that business school professors must be willing and able to accept failure as a part of the process. He believed that the most successful adopters of Google technology will be those that have embraced the willingness to fail in order to drive to a higher level of success.

In 2010, Google was seen as a global leader in technology that was focused on the ways people obtained information. Simply by its growth and product and application development,

EXHIBIT 2
Products and Services
2010: Google Inc.

GOOGLE.COM—SEARCH ENGINE AND PERSONALIZATIONS
Google Images
Google Books
Google Scholar
Google News
Google Finance
Google Videos
Google Blog Search
iGoogle and Personalized Search
Google Product Search
Google Merchant Search
Google Custom Search
Google Trends
Google Music Search
Google Webmaster Tools

APPLICATIONS
Google Docs
Google Calendar
Gmail
Google Groups
Google Reader
Orkut
Blogger
Google Sites
YouTube

CLIENTS
Google Toolbar
Google Chrome
Google Chrome OS
Google Pack
Picasa
Google Desktop

GOOGLE GEO—MAPS, EARTH, AND LOCAL
Google Local Search
Google Maps
Panoramio
Google Earth
Google SketchUp

ANDROID AND GOOGLE MOBILE
Google Mobile
Mobile Search
Mobile Applications
Mobile Ads

GOOGLE CHECKOUT

GOOGLE LABS

the company had one of the strongest brand recognitions in the world. There were three primary groups served by Google: (1) Users, (2) Advertisers, and (3) Google Network Members and Other Content Providers. Users gained the ability to find information quickly and easily on the Internet. Advertisers provided 97% of the revenue for Google and gained cost-effective online and offline ads to reach their target market as determined partially by Internet click history. Finally, Google Network Members gained access to AdSense, which allowed for multiple consumer contacts and revenue-sharing among the companies. A full list of products and applications is presented in **Exhibit 2**.

Management and Board of Directors

In 2002, Google hired former Sun Microsystems executive Eric Schmidt to assume the role as Chairman and, later in the same year, CEO. Cofounders Sergey Brin and Larry Page were active members of the Board of Directors. Members of the Executive Team and the Board of Directors are listed in **Exhibit 3**.

EXHIBIT 3

Executive Team and Board of Directors: Google Inc.

A. EXECUTIVE TEAM

Eric Schmidt, 54, Chairman of the Board and CEO, joined Google in 2001 and helped grow the company from a Silicon Valley startup to a global enterprise. Prior to joining Google, Schmidt was the Chief Technology Officer at Sun Microsystems and the President of Sun Technology Enterprises.

Sergey Brin, 36, cofounder, served as a member of the board of directors since Google's inception in September 1998 and as the President of Technology since July 2001. From September 1998 to July 2001, Sergey served as President. Sergey holds a Masters degree in computer science from Stanford University and a Bachelor of Science degree with high honors in mathematics and computer science from the University of Maryland at College Park.

Larry Page, 37, cofounder, has served as a member of the board of directors since Google's inception in September 1998 and as the President of Products since July 2001. Larry served as Chief Executive Officer from September 1998 to July 2001 and as Chief Financial Officer from September 1998 to July 2002. Larry holds a Masters degree in computer science from Stanford University and a Bachelor of Science degree in engineering, with a concentration in computer engineering, from the University of Michigan.

Nikesh Arora, 41, has served as President, Global Sales Operations and Business Development, since April 2009. Prior to that, Nikesh worked for Deutsche Telekom, Putnam Investments, and Fidelity Investments.

David C. Drummond, 46, served as Senior Vice President of Corporate Development since January 2006 and as Chief Legal Officer since December 2006. Prior to joining Google, David served as Chief Financial Officer of SmartForce, an educational software applications company.

Patrick Pichette, 47, served as Chief Financial Officer and Senior Vice President since August 2008. Prior to joining Google, Patrick served as President–Operations for Bell Canada, a telecommunications company.

Jonathan J. Rosenberg, 48, served as Senior Vice President of Product Management since January 2006. Prior to joining Google, Jonathan served as Vice President of Software for palmOne, a provider of handheld computer and communications solutions, and held various executive positions at Excite@Home, an Internet media company.

Shona L. Brown, 43, served as Senior Vice President of Business Operations since January 2006. Prior to joining Google, Shona was at McKinsey & Company, a management consulting firm, where she had been a partner in the Los Angeles office since December 2000.

Alan Eustace, 53, served as Senior Vice President of Engineering and Research since January 2006. Previously, he served as a Vice President of Engineering since July 2002. Prior to joining Google, Alan was at Hewlett-Packard, a provider of technology products, software, and services.

B. BOARD OF DIRECTORS

Eric Schmidt, 54, served as Chairman of the Board from 2001 to 2004 and from 2007 to the present, as well as Chief Executive Officer and board member since 2001.

Sergey Brin, 36, was cofounder and President of Technology. He served on the board since its inception in 1998.

Larry Page, 37, was cofounder and President of Products. He served on the board since its inception in 1998.

L. John Doerr, 58, served as board member since 1999. He has been General Partner of the venture capital firm Kleiner Perkins Caufield since August 1980.

John L. Hennessy, 57, served as Lead Independent Director since 2007. He served on the board since 2004. He has been President of Stanford University since 2000 and previously served as Dean of the Stanford School of Engineering and Chair of the Stanford Department of Computer Science.

Ann Mather, 49, served as board member since 2005. She also served as Executive Vice President and Chief Financial Officer of Pixar from 1999 to 2004 and held various executive positions at Village Roadshow Pictures and Walt Disney Company.

Paul S. Otellini, 59, served as board member since 2004. He has been CEO and President of Intel Corporation since 2005 and served previously in various Intel executive positions.

K. Ram Shriram, 52, served as board member since 1998. He has been Managing Partner of Sherpalo Ventures, an angel venture investment company, since 2000. He previously served as VP of Business Development at Amazon.com.

Shirley M. Tilghman, 63, served as board member since 2005. She has been President of Princeton University since 2001. Previously she served as Professor of Biochemistry and Founding Director of Princeton's multidisciplinary Lewis-Sigler Institute for Integrative Genomics.

SOURCE: *Google Forms 10-K and 14-A (2009).*

Mission

Google's mission was to organize the world's information and make it universally accessible and useful. Management believed that the most effective, and ultimately the most profitable, way to accomplish the company's mission was to put the needs of the users first. They found that offering a high-quality user experience led to increased traffic and strong word-of-mouth promotion. "The perfect search engine would understand exactly what you mean and give back exactly what you want," explained cofounder Larry Page.[5]

The complete mission statement is provided in **Exhibit 4**. Management extended the company's mission statement by providing guiding principles for the company, as shown in **Exhibits 5 and 6**.

EXHIBIT 4
Mission Statement: Google Inc.

Google's mission was to organize the world's information and make it universally accessible and useful. Management believed that the most effective, and ultimately the most profitable, way to accomplish their mission was to put the needs of the users first. They found that offering a high-quality user experience led to increased traffic and strong word-of-mouth promotion. Dedication to putting users first was reflected in three key commitments:

- Google will do its best to provide the most relevant and useful search results possible, independent of financial incentives. Its search results would be objective, and the company did not accept payment for search result ranking or inclusion.
- Google will do its best to provide the most relevant and useful advertising. Advertisements should not be an annoying interruption. If any element on a search result page is influenced by payment to the management, it will make it clear to our users.
- Google will never stop working to improve the user experience, its search technology, and other important areas of information organization.

Management believed that their user focus was the foundation of their success to date. They also believed that this focus was critical for the creation of long-term value. Management stated they did not intend to compromise their user focus for short-term economic gain.

SOURCE: *Google Form 2009 10-K, modified by case author.*

EXHIBIT 5
The Philosophy: Google Inc. Ten Things We Know to Be True

1. Focus on the user and all else will follow.
2. It's best to do one thing really, really well.
3. Fast is better than slow.
4. Democracy on the web works.
5. You don't have to be at your desk to need an answer.
6. You can make money without doing evil.
7. There's always more information out there.
8. The need for information crosses all borders.
9. You can be serious without a suit.
10. Great just isn't good enough.

SOURCE: *http://www.google.com/corporate/tenthings.html, accessed October 15, 2010.*

EXHIBIT 6
Principles that Contribute to a Google User's Experience

1. Focus on people, their lives, their work, their dreams.
2. Every millisecond counts.
3. Simplicity is powerful.
4. Engage beginners and attract experts.
5. Dare to innovate.
6. Design for the world.
7. Plan for today's and tomorrow's business.
8. Delight the eye without distracting the mind.
9. Be worthy of people's trust.
10. Add a human touch.

SOURCE: *http://www.google.com/corporate/ux.html, accessed October 15, 2010.*

Issues and Risk Factors Facing Google in 2010[6]

Competition

According to top management, Google's industry was characterized by rapid change and converging, as well as new and disruptive, technologies. Google faced formidable competition in every aspect of its business, particularly from companies that sought to connect people with information on the web and provide them with relevant advertising. Google faced significant direct and indirect competition from:

- **Traditional search engines, such as Yahoo! Inc. and Microsoft Corporation's Bing.** Although Yahoo! was the first search engine to gain widespread acceptance, it lost its dominant position to Google when Google introduced its superior search engine technology. Microsoft's failed attempt to buy Yahoo! in 2008 led to the introduction of Bing, its own search engine, in 2010. Microsoft's marketing power could make Bing a serious competitor to Google. Some industry statistics are listed in **Exhibit 7.**
- **Vertical search engines and e-commerce sites, such as WebMD (for health queries), Kayak (travel queries), Monster.com (job queries), and Amazon.com and eBay (commerce).** Google competed with these sites because they, like Google, were trying to attract users to their websites to search for product or service information, and some users may navigate directly to those sites rather than go through Google.
- **Social networks, such as Facebook, Yelp, or Twitter.** Some users were beginning to rely more on social networks for product or service referrals, rather than seeking information through traditional search engines.
- **Other forms of advertising.** Google competed against traditional forms of advertising, such as television, radio, newspapers, magazines, billboards, and yellow pages, for ad dollars.
- **Mobile applications.** As the mobile application ecosystem developed further, users were increasingly accessing e-commerce and other sites through those companies' stand-alone mobile applications, instead of through search engines.
- **Providers of online products and services.** Google provided a number of online products and services, including Gmail, YouTube, and Google Docs, that competed directly with new and established companies that offered communication, information, and entertainment services integrated into their products or media properties.

EXHIBIT 7
Direct Competitor Comparison 2010

	Google	AOL	Yahoo	Industry
Market cap ($)	186.01B	2.65B	21.05B	87.07M
Employees	23,331	6,700	13,900	289
Quarterly revenue growth	22.60%	–26.20%	1.60%	28.50%
Revenue ($)	27.55B	2.65B	6.53B	82.12M
Gross margin	64.15%	42.78%	56.83%	61.03%
EBITDA ($)	11.26B	788.00M	1.40B	7.09M
Operating margin	35.86%	17.27%	11.21%	3.63%
Net income ($)	7.94B	–924.60M	1.07B	N/A
Earnings per share ($)	24.62	–7.96	0.77	0.02
Price/earnings	23.63	N/A	20.97	22.16
Price/earnings to growth	1.21	–1.12	1.45	1.39
Price/sales	6.86	1.02	3.3	2.21

SOURCE: *http://finance.yahoo.com/q/co?s=GOOG, accessed on November 23, 2010.*

Google competed to attract and retain users of its search and communication products and services. Most of the products and services offered to users were free, so Google did not compete on price. Instead, the company competed in this area on the basis of the relevance and usefulness of search results and the features, availability, and ease of use of Google's products and services.

Neither Google's users nor its advertisers were locked into Google. For users, other search engines were literally one click away, and there were no costs to switching search engines. Google's advertisers typically advertised in multiple places, both online and offline. The company competed to attract and retain content providers (Google Network members, as well as other content providers for whom the company distributed or licensed content) primarily based on the size and quality of Google's advertiser base. Google's ability to help these partners generated revenues from advertising and the terms of the agreements. Since 97% of Google's revenues were generated from advertising, this placed the company in a tight position if any advertising contracts were to dissolve or diminish in growth. However, Google was reliant on strong brand recognition and its brand identity.[7]

Legal and Regulatory Issues

Google was subject to increased regulatory scrutiny that may have negatively impacted the business. This was an increased risk with continued growth and corporate expansion. There may be regulatory issues related to potential monopolistic power as the industry faced both growth with expansion and consolidation.

Legal issues were a developing concern for Google. Many laws currently in place had been enacted prior to the Internet age and thus could not have taken into consideration the business practices and implications of the Internet and computer technology. Liability issues, such as laws related to the liability of online services, remained uncertain and were thus a legal risk for Google.

The Digital Millennium Copyright Act contained provisions that limited, but did not eliminate, Google's liability for listing or linking to third-party websites that included materials that infringed copyrights or other rights, so long as the company complied with the statutory requirements of the act. Various U.S. and international laws restricted the distribution of materials considered harmful to children and imposed additional restrictions on the ability of

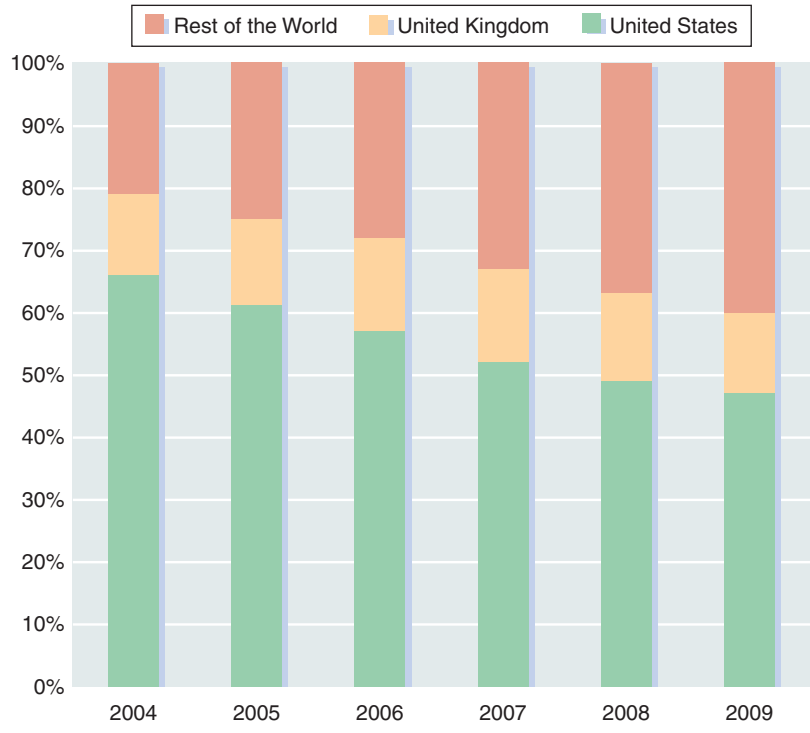
online services to collect information from minors. Furthermore, in the area of data protection, many states had passed laws requiring notification to users when there was a security breach of personal data. One example was California's Information Practices Act.[8]

International Risk

Google's international revenues were increasing annually, and amounted to 51% of corporate revenues in 2008. (See **Exhibit 8**.) Over half of user traffic in 2009 was international. There were increased challenges with international operations which included, but were not limited to, geographic, language, and cultural differences among countries. Countries had different accounting practices, and the credit risk was generally greater for international transactions. Furthermore, exchange rate risk, potential negative tax consequences, foreign exchange controls, and cultural barriers related to customers, employees, and other stakeholders were more prevalent with international dealings. Privacy laws and government censorship often varied among countries.

Government pressure led Google to censor its web content in numerous locations. For example, it was illegal to publish material in Germany, France, and Poland that denied the Holocaust. Google thus used filters to screen for such material. In Turkey, videos that mocked "Turkishness" were filtered by Google for its *Google.com.tr* website. Since China restricted Internet content and political speech, Google had to agree to censor some of its Internet search results to establish its *Google.com.cn* website in 2006. Google's management made the controversial decision in early 2010 to move its China website from China.cn where it had been under heavy censorship pressure to its site in Hong Kong (Google.hk) that wasn't filtered. According to management, there was clearly a benefit from international transactions that in general outweighed the costs.[9]

EXHIBIT 8
Revenues by Geographic Area



SOURCE: *Google Form 10-K (2009).*

Internet Security Issues

Internet security was an issue that plagued the industry, as a security breach would be potentially harmful to Google. Sophisticated software could already track users' Internet activity while they shopped for goods and services on the web. Skilled hackers from around the world were now able to enter supposedly "secure" websites to obtain user records and credit card information. Identity theft was becoming a major problem for the general population. Security/privacy issues were likely to become even more important as the amount of data and applications available on the Internet increased.

Revenue Growth and Sustainability

Google had experienced remarkable revenue growth in the past six years as evidenced by its financial statements. See **Exhibits 9 and 10** for balance sheets, and income statements for 2004–2009. Google's management recognized that the firm's revenue growth rate may soon decrease due to stronger direct and indirect competition, the developing maturity of the online advertising market, and the growing size of the firm. This could put pressure on operating margins and profits in the future, thus lowering the free cash flow available to investors. Google's management recognized that future profit margins may be tightened further by lower profit margins on revenues received from Google Network members. Furthermore, since 97% of revenue came from advertising, any blockage of online advertising would have a negative effect on operating profits.

Intellectual Property

Google, YouTube, DoubleClick, DART, AdSense, AdWords, Gmail, I'm Feeling Lucky, PageRank, Blogger, orkut, Picassa, SketchUp, and Postini were registered trademarks in the United States. Google also had unregistered trademarks, such as Blog*Spot, Jaiku, Android, Open Handset Alliance, OpenSocial, Panoramio, and Knol. The first version of the PageRank technology was created while Google's cofounders attended Stanford University—thus, Stanford owned a patent to PageRank which was due to expire in 2017. Although Google owned a perpetual license to this patent, the license was due to become non-exclusive at the end of 2011.

Google must fend off threats to their trademarks and secrets. Mainly, the company runs the risk of the name *Google* becoming commonly used by the public to describe "searching" the Internet. Google could actually lose its trademark on the name, as it would become part of the public domain. Trade secrets are also something Google defended, as an internal leak would diminish the value of these secrets.

Furthermore, intellectual property rights claims were costly to defend in the legal system. Litigations challenging the IP rights of companies within the technology industry were frequent, and as Google expanded its business, it had experienced more claims against it. Companies had filed trademark infringements against Google, usually over advertisements. Companies have also filed claims against Google for copyright infringement on the features of its website and its products. Examples include the class action settlement with the Authors Guild and the Association of the American Publishers, which will end up costing the company. In addition, some of Google's products have been attacked for patent infringements, for which Google could be required to pay damages or licensing fees. Patent infringement settlements would lead to higher costs and prevent the ability of Google to produce certain services or products, leading to lost profits.

EXHIBIT 9

Balance Sheet: Google Inc. (Dollar amount in millions)

Year Ending December 31	2004	2005	2006	2007	2008	2009
Assets						
Current assets						
Cash and cash equivalents	$426,873	$3,877,174	$3,544,671	$6,081,593	$8,656,672	$10,197,588
Marketable securities	1,705,424	4,157,073	7,699,243	8,137,020	7,189,099	14,287,187
Accounts receivable	311,836	687,976	1,322,340	2,162,521	2,642,192	3,178,471
Deferred income taxes, net	19,463	49,341	29,713	68,538	286,105	644,406
Income taxes receivable	70,509	0	0	145,253	0	23,244
Prepaid revenue share, expenses, and other assets	159,360	229,507	443,880	694,213	1,404,114	836,062
Total current assets	2,693,465	9,001,071	13,039,847	17,289,138	20,178,182	29,166,958
Prepaid revenue share, expenses, and other assets, noncurrent	35,493	31,310	114,455	168,530	433,846	416,119
Deferred income taxes, net, noncurrent	11,590	0	0	33,219	0	262,611
Nonmarketable equity securities	0	0	1,031,850	1,059,694	85,160	128,977
Property and equipment, net	378,916	961,749	2,395,239	4,039,261	5,233,843	4,844,610
Intangible assets, net	71,069	82,783	346,841	446,596	996,690	774,938
Goodwill	122,818	194,900	1,545,119	2,299,368	4,839,854	4,902,565
Total assets	$3,313,351	$10,271,813	$18,473,351	$25,335,806	$31,767,575	$40,496,778
Liabilities and stockholders' equity						
Current liabilities						
Accounts payable	$32,672	$115,575	$211,169	$282,106	$178,004	$215,867
Accrued compensation and benefits	82,631	198,788	351,671	588,390	811,643	982,482
Accrued expenses and other current liabilities	64,111	114,377	266,247	465,032	480,263	570,080
Accrued revenue share	122,544	215,771	370,364	522,001	532,547	693,958
Deferred revenue	36,508	73,099	105,136	178,073	218,084	285,080
Income taxes payable, net	0	27,774	0	0	81,549	0
Current portion of equipment leases	1,902	0	0	0	0	0
Total current liabilities	340,368	745,384	1,304,587	2,035,602	2,302,090	2,747,467
Deferred revenue, long-term	7,443	10,468	20,006	30,249	29,818	41,618
Liability for stock options exercised early, long-term	5,982	2,083	40,421	0	890,115	1,392,468
Deferred income taxes, net	1	35,419	0	478,372	12,515	0
Other long term liabilities	30,502	59,502	68,497	101,904	294,175	311,001
Commitments and contingencies						
Stockholder's equity						

EXHIBIT 9
(Continued)

Convertible preferred stock, $0.001 par value, 100,000 shares authorized; no shares issued and outstanding	0	0	0	0	0	0
Class A and Class B common stock, $0.001 par value: 9,00,000 shares	267	293	309	313	315	318
Additional paid-in capital	2,582,352	7,477,792	11,882,906	13,241,221	14,450,338	15,816,738
Deferred stock-based compensation	(249,470)	(119,015)	0	0	0	0
Accumulated other comprehensive income	5,436	4,019	23,311	113,373	226,579	105,090
Retained earnings	**590,471**	**2,055,868**	**5,133,314**	**9,334,772**	**13,561,630**	**20,082,078**
Total stockholders' equity	**2,929,056**	**9,418,957**	**17,039,840**	**22,689,679**	**28,238,862**	**36,004,224**
Total liabilities and stockholders' equity	**$3,313,351**	**$10,271,813**	**$18,473,351**	**$25,335,806**	**$31,767,575**	**$40,496,778**

SOURCE: *Google Form10-K (2009).*

EXHIBIT 10
Income Statement: Google Inc. (Dollar amount in millions)

Year Ending December 31	2004	2005	2006	2007	2008	2009
Revenues	$3,189,223	$6,138,560	$10,604,917	$16,593,986	$21,795,550	$23,650,563
Costs and expenses						
Cost of revenues	1,468,967	2,577,088	4,225,027	6,649,085	8,621,506	8,844,115
Research and development	395,164	599,510	1,228,589	2,119,985	2,793,192	2,843,027
Sales and marketing	295,749	468,152	849,518	1,461,266	1,946,244	1,983,941
General and administrative	188,151	386,532	751,787	1,279,250	1,802,639	1,667,294
Contribution to Google Foundation	0	90,000	0	0	0	0
Nonrecurring portion of settlement of disputes with Yahoo	201,000	0	0	0	0	0
Total costs and expenses	2,549,031	4,121,282	7,054,921	11,509,586	15,163,581	15,338,377
Income from operations	640,192	2,017,278	3,549,996	5,084,400	6,631,969	8,312,186
Interest income and other, net	10,042	124,399	461,044	589,580	316,384	69,003
Impairment of equity investments	0	0	0	0	(1,094,757)	0
Income before income taxes	650,234	2,141,677	4,011,040	5,673,980	5,853,596	8,381,189
Provision for income taxes	251,115	676,280	933,594	1,470,260	1,626,738	1,860,741
Net income	$399,119	$1,465,397	$3,077,446	$4,203,720	$4,226,858	$6,520,448
Net income per share of Class A and Class B common stock						
Basic	$2.07	$5.31	$10.21	$13.53	$13.46	$20.62
Diluted	1.46	5.02	9.94	13.29	13.31	20.41
Shares outstanding (mil)	267	293	309	313	315	318
Year-end stock price	$192.79	$414.86	$460.48	$691.48	$307.65	$619.98

SOURCE: *Google Form 10-K (2009).*

Alternative Technology

Each day, more individuals were using devices other than personal computers to access the Internet. If users of these devices did not widely adopt versions of Google's web search technology, products, or operating systems developed for these devices, the business could be adversely affected. These alternative devices may make it problematic to use the services provided by Google, and make it challenging for the company to produce products which capture customers' imaginations and loyalties.

Information Technology Issues

Google was susceptible to threats from false or invalid visits to the ads it displayed, and has had to refund fees charged for advertising due to fraudulent clicks. If Google failed to detect click fraud or other invalid clicks, it could lose the confidence of its advertisers, which would harm the company's image and viability.

Additionally, interruption or failure of the information technology and communications systems the company used could hurt its ability to effectively provide products and services, damaging the reputation Google worked to maintain, as well as harming its operating income. Its IT system was exposed to impairment from numerous sources, such as natural disasters, infrastructure failures, and computer hackers. Although management had contingency plans for many of these situations, such plans could not cover every possibility.

Index spammers could harm the integrity of Google's web service by falsifying users' search attempts. This could damage the company's reputation and lead to users becoming unhappy with Google's products and services, leading to a decline in website visits. This could result in lower advertising revenues from its Google Network partners. Google relied greatly on these members for a significant portion of its revenues, and both parties benefited from their association with each other. The loss of these associates could adversely affect the business.

The future of the business depended upon continued and unimpeded access to the Internet for both the company and its users. Internet access providers may be able to block, degrade, or charge for access to certain Google products and services, which could lead to additional expenses and the loss of users and advertisers.

As Google spread its operations across the globe, more and more of its receivables were being denominated in foreign currencies. If currency exchange rates become unfavorable, the company could lose some revenues in U.S. dollar terms. Although many multinational corporations used hedging strategies to lower or negate the risk of doing business overseas, Google had limited experience with many of these financial strategies. Hedging strategies also had high costs, reducing the company's overall profitability.

Culture and Employees

Like many successful technology firms, Google provided its employees with an open and collaborative culture in which ideas were exchanged and new products and application ideas were developed. Google's management strived to be transparent in their workings, making sure that employees knew about company announcements and new product or application development before the public. The company used both technology and standard processes to convey information. For example, "Tech Talks" blogs and weekly "TGIF" meetings were used to convey information and to communicate with employees.

On December 31, 2009, Google had 19,835 employees, consisting of 7,443 in research and development, 7,338 in sales and marketing, 2,941 in general and administrative, and 2,113 in operations. Given that Google relied on highly skilled workers, its continued success was strongly related to its ability to maintain and grow its strong talent pool. Once the current recession ends, it may become more difficult to attract and maintain skilled, talented employees.[10]

Google experienced rapid and strong growth with strong employee satisfaction. The company worked to gain a globally diverse workforce with different perspectives in which

employees were rewarded for performance. Google had historically worked hard to maintain a corporate culture of innovation and performance that aligned the interests of the corporation with those of employees. The company's $1,000 cash bonus and 10% raise paid to all of its employees in 2010 were examples of the lengths to which the company acted to retain top talent. This was important since Google's stock price had dropped 4.7% in 2010. According to Paul Kedrosky, a venture capitalist, "It used to be people were fine taking Google's money and stock, because they believed it would appreciate rapidly. Not it's not as attractive."[11]

The company considered cofounders Brin and Page to be a key corporate resource, even though their spending $15 million for a former Qantas Boeing 767 jet airplane in 2006 to use as a company plane was listed by *Bloomberg Business Week* as an example of "executive excess."[12]

As the company continues to grow, management will be challenged to find new and innovative ways to maintain a strong corporate culture.

Seasonality

While there were some seasonal effects on Google's business, it was generally not as significant as in retail stores, which earned much of their revenue in the last quarter of the calendar year. In Google's case, there had generally been an increase in business in the last quarter of the calendar year, as represented by commercial queries. Likewise, the summer months tended to be the slowest time of the year. While seasonality might be an issue for Google's business and revenue, it was generally not perceived by management to be a major issue.

Google's Future

Google had thus far thrived in the Internet search engine industry, garnishing a name that, for many, was synonymous with "Internet search." Up to now, growth had been strong, suggesting a bright future. Google appeared to be poised to take advantage of what the future had to offer in new technology by creating new products. In order to continue doing this, it will need to retain the best and brightest minds. For example, one of Google's new concepts was artificial intelligence software for use in automobiles that could drive themselves.[13] The company's stock price had climbed tremendously in the past, but some analysts now felt that Google was maturing as a corporation and that its stock value was leveling off.[14]

As Google continued to grow, it continued purchasing other companies, such as its acquisitions of YouTube, DoubleClick, and Postini.[15] Nevertheless, growth by acquisition may not necessarily lead to increasing growth in revenues or profits. For example, YouTube was an $1.6 billion 2006 acquisition that as of 2010 had not generated significant additional revenue for Google, despite its growth potential.

There were some indications that acquisitions might become an increasingly difficult strategy in the future. In 2010, Google failed in an attempt to purchase Groupon, a website specializing in local shopping promotions. Google's offer of $6 billion for Groupon was almost double what it had paid for DoubleClick in 2008. Groupon's rejection of the offer reflected a fear common to web entrepreneurs that their small ventures might get lost inside Google's vastness. For example, several other startups, such as Yelp, that had also been pursued by Google had opted to stay privately owned.[16]

Google's top management needed to consider these and other factors in order to plan strategically. Legal issues will likely continue, such as allegations that Google used Wi-Fi networks to take personal information. Google's management had moved on this quickly with corrective action and similar future responses to legal challenges will be important.[17] The future of mobile computing was an open, uncharted area.[18]

All of these considerations and more were relevant as CEO Schmidt and his executive team pondered the second decade of the new millennium and discussed Google's future strategies.

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CASE 13

Reorganizing Yahoo!

P. Indu and Vivek Gupta

"We're putting the right people in the right places to execute our focused growth strategy. Yahoo! has an extraordinarily skilled and experienced group of senior executives and we're adding outside senior talent to this already strong team. Our new structure gives us the opportunity to draw more fully on Yahoo!'s deep bench of talent, both at the new group level and down through the organization, while also increasing accountability, reducing bottlenecks and speeding decision-making. We'll also continue to drive sustained innovation by recruiting, developing and retaining the best talent in our industry."[1]

TERRY SEMEL, CHAIRMAN & CEO, YAHOO!, ON THE COMPANY'S REORGANIZATION PROGRAM ANNOUNCED IN 2006.

"This is just the beginning of what Yahoo! needs to do. It may take all of 2007. Change like this is evolutionary, not revolutionary. The new division heads will need time to grasp the enormity of the task at hand."[2]

JORDAN ROHAN, ANALYST RBC CAPITAL MARKETS[3] ON YAHOO!'S REORGANIZATION, IN 2006.

Introduction

ON FEBRUARY 05, 2006, U.S.-BASED INTERNET SERVICES COMPANY YAHOO! INC. (Yahoo!) moved all its advertisers to a new ranking model called 'Panama' in order to regain customers who had shifted to the Google's[4] more popular AdWords.[5] Yahoo!'s new algorithm and ranking model would rank the advertisements based on the highest bid on search keywords by the advertiser and the number of clicks. Industry analysts opined that with the new model, Yahoo! would be in a better position to challenge Google. Panama received encouraging reviews from the customers and the advertisers. According to Marianne Wolk, analyst at Susquehanna Financial Group,[6] "The early feedback on Panama is strong. Click-through rates are better than expected."[7]

In December 2006, prior to the launch of Panama, Yahoo! had announced that it was reorganizing the company. The reorganization became necessary as Yahoo! found itself unable to generate enough revenues from search-related advertising despite being the most visited Web site on the Internet. Between July 2005 and July 2006, Yahoo!'s share in total online searches in the United States went down from 30.5% to 28.8% (see **Exhibit 1** for share of online searches by engine in July 2005 and July 2006).

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EXHIBIT 1
Share of Online Searches by Engine[1]

	July 05	June 06	July 06	% Change
Google Sites	36.5	44.7	43.7	4.2
Yahoo! Sites	30.5	28.5	28.8	–1.7
MSN Microsoft sites	15.5	12.8	12.8	–2.7
Times Warner Network	9.9	5.6	5.9	–4.0
Ask Network	6.1	5.1	5.4	–0.7

Note:[1] Total work, home and university Internet users in the United States, Internet population is 100%.

SOURCE: *www.comscore.com.*

In spite of total revenues going up from US$5,257.67 million in 2005 to US$6,425.68 million in 2006, Yahoo!'s net income fell from US$1,896.22 million to US$751 million (see **Exhibit 2** for Yahoo!'s Income Statement between 2001 and 2006). According to analysts, the problem was that Yahoo! was not focusing on any particular product, but was trying instead to cater to different customers through a single portal. Though Yahoo! acquired several companies, it failed to integrate

EXHIBIT 2
Income Statement: Yahoo!, Inc.
(Dollar amounts in millions)

Year Ending December 31	2006	2005	2004	2003	2002	2001
Total Revenue	**$6,425.68**	**$5,257.67**	**$ 3,574.52**	**$1,625.10**	**$953.07**	**$ 717.42**
Cost Revenue	2,669.10	2,096.20	1,342.34	370.09	162.88	157.00
Gross Profit	**3,756.58**	**3,161.47**	**2,232.18**	**1,255.01**	**790.19**	**560.42**
Selling, General, Adm Expenses	2,002.48	1,397.41	1,072.92	709.67	539.05	470.91
Research & Development	688.34	547.14	368.76	207.28	141.77	121.47
Depreciation/Amortization	124.79	109.19	101.92	42.38	21.19	64.08
Unusual Income (Expense)						63.23
Total Operating Expense	2,815.61	2,053.74	1,543.60	959.33	702.01	719.69
Operating Income	940.97	1,107.73	688.58	295.68	88.18	–159.27
Interest Income, Net Non-Operating	139.78	1,092.45	475.95	45.98	87.69	4.36
Gain (Loss) on Sales of Assets	15.16	337.96				
Other, Net	2.09	5.44	20.49	1.53	2.35	72.09
Income Before Tax	1,098.00	2,543.58	1,185.02	343.19	178.22	–82.82
Income After Tax	**458.01**	**767.82**	**437.97**	**147.04**	**71.28**	**–9.97**
Minority Interest	–0.71	–7.78	–2.50	–5.92		
Equity in Affiliates	112.11	128.24	94.99	47.65		
Net Income	**$ 751.39**	**$1,896.22**	**$ 839.54**	**$ 237.88**	**$106.94**	**$ –92.79**

Consolidated Balance Sheets Data:

	December 31,				
	2002	2003	2004	2005	2006
			(In thousands)		
Cash and cash equivalents	$ 234,073	$ 415,892	$ 823,723	$ 1,429,693	$ 1,569,871
Marketable debt securities	$1,299,965	$2,150,323	$2,918,539	$ 2,570,155	$ 1,967,414
Working capital	$ 558,190	$1,013,913	$2,909,768	$ 2,245,481	$ 2,276,148
Total assets	$2,790,181	$5,931,654	$9,178,201	$10,831,834	$11,513,608
Long-term liabilities	$ 84,540	$ 822,890	$ 851,782	$ 1,061,367	$ 870,948
Total stockholders' equity	$2,262,270	$4,363,490	$7,101,446	$ 8,566,415	$ 9,160,610

SOURCES: *finance.google.com and 2006 Annual Report, Yahoo!, Inc., 1.33.*

them. Even in search-related advertising, which had emerged as a major revenue generator in the Internet business, Yahoo! fell behind its competitor Google, which was generating twice as much revenue on each search ad. The challenges that Yahoo! was facing externally were further compounded by the internal turmoil in the company brought about by the complex organization structure and slow decision-making process.

Yahoo! delayed several product launches as it wanted to focus on Panama, which had been delayed by more than two quarters. Panama was to be launched in the second quarter of 2006 but was not launched even at the end of 2006. Yahoo!'s problems were reported widely in the media. At the same time, the *Wall Street Journal*[8] published an internal memo that was circulated by a senior vice president at Yahoo!, about the lack of focus in the company due to which its resources were thinly spread across several business segments.

Within a month, Yahoo! introduced a new organization structure, under which the company was reorganized into three operating units, namely the Audience Group, the Advertiser & Publisher Group, and the Technology Group with the focus on the customers, advertisers, and technology, respectively. The heads of the three units reported directly to Terry Semel (Semel), chairman & CEO of Yahoo!.

Analysts opined that with the reorganization and Panama in place, Yahoo! could well be on its way to regaining its lost glory. According to Martin Pyykkonen, analyst, Global Crown Capital,[9] "I'm not forecasting any kind of wholesale shift here, that all of a sudden Google is going to fall by the wayside … but I do think they (Yahoo!) will narrow the gap."[10]

Background Note

Yahoo! was founded by Jerry Yang and David Filo, who began exploring the Internet as a hobby after finishing their doctoral theses in electrical engineering at Stanford University. In April 1994, they created a directory to keep track of their personal interests on the Internet. Gradually, they began to spend more and more time on their directory. Later, Yang and Filo started categorizing Web sites as a way to keep track of all the sites they had visited. They posted this list on the Web as "Jerry and David's Guide to the Worldwide Web."

The guide became very popular and became the first choice of people browsing the Web to find sites intelligently. It helped people to discover useful, interesting, and entertaining content on the Internet. In late 1994, the duo changed the name of the guide to Yahoo!,[11] positioning it as a customized database designed to serve different users. They developed customized software to help locate, identify, and edit material stored on the Internet. Yahoo! rapidly became popular and attracted a lot of media attention.

Yahoo! was formally incorporated in March 1995, and by mid-1995 it had implemented a business plan modeled on traditional broadcast media companies. Through its IPO in April 1996, Yahoo! sold 2.6 million shares, raising US$38.8 million.

Yahoo! generated its revenues mainly from online advertisements, primarily banner ads[12] and ad placement fees, promotions,[13] sponsorships, direct marketing,[14] and merchandising. It also generated revenues from monthly hosting fees and commissions on online sales from its merchant partners. These included transaction fees generated from the sale of merchandise on its site.

Within the four years from 1997 to 2000, Yahoo! reported substantial growth in its revenues. More than 85% of its revenues came from the sale of banners and sponsorship advertising while the remaining came from business services and e-commerce transactions. By mid-2000, Yahoo! was drawing more than 180 million unique visitors,[15] which made Yahoo! a leading Internet brand.

In late 2000, Yahoo! faced several problems owing to the internal rivalry between President Jeffrey Mallett and CEO Timothy A Koogle (Koogle). Its troubles were compounded by the fact that the company had grown complacent and did not adapt to the rapidly changing business environment. Yahoo! was heavily dependent on the advertising revenues generated through dotcoms. Once the dotcoms began going out of business, Yahoo!'s ad revenues declined sharply. The

online advertising market was going through major changes, and the advertisers were looking beyond the banner ads, toward ads that integrated the Internet, television, and radio. Yahoo!, however, did not understand what kind of advertising would work for the customers. It failed to make any improvements in its business models, which would have allowed it to cater to a wide range of customers. Several key personnel also left the company during the time.

In the first quarter of 2001, with a sharp decline in online advertisement sales, Yahoo! reduced its revenue forecast from US$230 million to US$175 million. At a board meeting convened in February 2001, it was decided that Koogle should step down, making way for Semel. Semel brought in several changes in the company and the number of business units was reduced from 44 to just five. He also announced the layoff of 400 people from Yahoo!'s 3,500 workforce. Several new services, including subscription-based services were introduced.

In order to consolidate its position, Yahoo! entered into several partnership deals. One such deal was with Overture, a paid search services[16] provider. The acquisitions made by Yahoo! included Hotjobs.com, an online careers site, in February 2002 for US$435 million, and Inktomi Corporation[17] in March 2003 for US$257 million. Yahoo! also entered into a licensing agreement with Google to use its search engine technology.

At the end of 2003, Yahoo! acquired Overture for around US$1.6 billion. At the time, Overture dominated search-related advertising, and its revenues were almost double that of Google. Through Overture's advertising platform, advertisers could select words and search phrases and bid for them. This enabled their advertisements to be shown along with the regular search results. As Overture was highly successful, analysts opined that Yahoo! was making the right moves and could consolidate its position in the rapidly growing online advertising market by acquiring Overture. With Inktomi and Overture,[18] Yahoo! was expected to become a domination force in the search advertising market (see **Exhibit 3** for online advertising market in the United States).

The Problems

Though Yahoo! possessed search engine and search advertising technology, integrating both proved to be a difficult task. The engineers in the company had to be convinced that, rather than build the new technology from scratch, it was better to use the acquired technology from Inktomi and Overture. In order to convince the engineers, Semel announced the integration of Yahoo!, Inktomi, and Overture to create the best search technology consumers and an effective advertising platform for the advertisers.

However, even until early 2004, Yahoo! continued using Google's search engine. In February 2004, Yahoo! launched a Web crawler–based[19] search engine, based on Yahoo! Slurp.[20] With the prevailing optimism about Yahoo!, its stock hit US$36.42 by mid-2004.

Through Overture, advertisements were placed depending on the amount the advertiser had agreed to pay per click. So the advertisements of the highest bidder were placed on the top, irrespective of their relevance. The technology used in Overture could not handle the high traffic expected out of a Yahoo! search. Overture required each advertisement to be reviewed and placed with human intervention, and this required a lot of time. To display advertisements based on relevance, Yahoo! needed to create new ranking software and a database to measure the clicks the advertisements were receiving. The company planned to spruce up technology and call the project Panama. However, the project ran into trouble with executives from Yahoo! and Overture not being able to work together. Meanwhile, by 2004, Google had surpassed Overture in terms of revenues. There were several other areas in which Yahoo! faced problems. According to analysts, Yahoo! had become a victim of it own success. The company had adopted the model of being a one-stop portal, offering all the services on its website. Over the years, Yahoo!'s home page grew highly cluttered. The difference was quite stark when compared to Google's home page. Google's home page was simple and user-friendly while Yahoo!'s homepage had links to a host of products and services, such as

EXHIBIT 3
A Note on Online Advertising Market in the U.S.

With the increase in the number of broadband connections, especially after 2000, an Internet advertising market began growing rapidly in the United States. The faster broadband connections offered advertisers an opportunity to dabble with rich media advertising. Moreover, limitations began to surface in the til-then most popular advertising channel, the television, making advertisers look for a better alternative in their efforts to reach the right kind of audience. This led to the emergence of online advertising, especially search-based advertising, where the advertisers chose to advertise only to their target audience. One of the first Internet advertising companies was GoTo.com, later named Overture, which pioneered the concept of paid search. The next player on the horizon was Google, which came out with the idea of payment for advertising according to the clicks the advertisement received. These advertisements were also contextual and were related to the content on the page. On similar lines, companies like Microsoft launched AdCenter and eBay launched AdContext.

Online advertising techniques include banners, pop-ups, pop-unders, search and display ads, and interactive advertising, etc. In display advertising, advertisers pay the online company for space to display the ad, which could be a hyperlinked banner, logo, etc. In the case of sponsorship, the advertisers sponsor a Web site or some of the pages on the website for a particular period. Advertisers opting to advertise through e-mail place their banner ads, links, or newsletters on the e-mails. Other forms of Internet advertising are lead generation, referrals, classifieds, auctions, rich media, and slotting fees.

It is search advertising that remains highly popular. In search advertising, a fee is paid by the advertisers to the online companies to list or link their site domain name to a specific search word or a search phrase. There are different types of search advertising. In paid listings, text links appear at the top of the search results. The advertiser pays only when users click the link. In contextual search, the text links of the advertisers appear depending on the context of the content, irrespective of the search word. Even in this, the advertisers pay the online company only when users click the links. Through paid inclusion, advertisers are guaranteed that their URL is indexed on a search engine.

In the year 2003, Internet advertising was the fastest-growing advertising medium, and by 2005 Internet advertising in the United States was valued at over US$12.5 billion, showing a growth of 30% over 2004. Internet advertising accounted for around 5% of the total advertising revenues in the United States in 2005.

In 2005, keyword search accounted for 34% of the total Internet ad revenue at US$5142 million. Display advertising's share was at 20% with US$2508 million, rich media was US$1003 million, sponsorship at US$627 million, slotting fee US$125 million, classifieds US$2132 million, e-mail US$251 million, and referrals/lead generation about US$753 million.

Advertising Market in the U.S. (2005)

Media	In US$ Million
Direct mail	56.6
Newspapers	47.9
Broadcast & Syndicated TV	35.0
Radio	21.7
Cable TV	18.9
Consumer Magazines	12.9
Internet	**12.4**
Business Magazines	7.8
Outdoor	6.2

Internet Advertising – Annual Revenues

Year	Revenue (In US$ Million)
1996	267
1997	907
1998	1,920
1999	4,621
2000	8,087
2001	7,134
2002	6,010
2003	7,267
2004	9,626
2005	12,452

SOURCE: *Adapted from IAB Internet Advertising Revenue Report and PricewaterhouseCoopers.*

e-mail, music, mobile, small business services, health, finance, games, movies, personals, etc. Tucked away among all these was a search engine. Some of the Yahoo! employees were of the opinion that the home page suffered "from too many cooks in the kitchen."[21] (See **Exhibit 4** for Yahoo!'s homepage in 1996 and see **Exhibit 5** for Yahoo!'s homepage in 2004.)

Yahoo! seemed unclear about its identity, about whether it was a portal, search engine, or a media company. At the same time, several sites such as Google, eBay,[22] and MySpace[23] were successful in their specialized area, and consumers shifted their preferences to those sites. In the process of diversifying into several areas, Yahoo! appeared to have lost its identity. According to Stewart Butterfield, director of project management, Yahoo!, and cofounder of Flickr,[24] "There's always been some ambiguity about whether it's a tech company or a media company."[25]

There were other problems too. For instance, Yahoo! was the most visited Web site on the Internet, with an average of 500 million monthly visitors as of mid-2006. The company's revenues for the first three quarters of 2006 stood at US$4.5 billion. On the other hand, Google, with 380 million visitors, recorded revenue of US$7.2 billion in the same period. This meant that Yahoo! was failing to generate enough revenues from the users visiting its site.

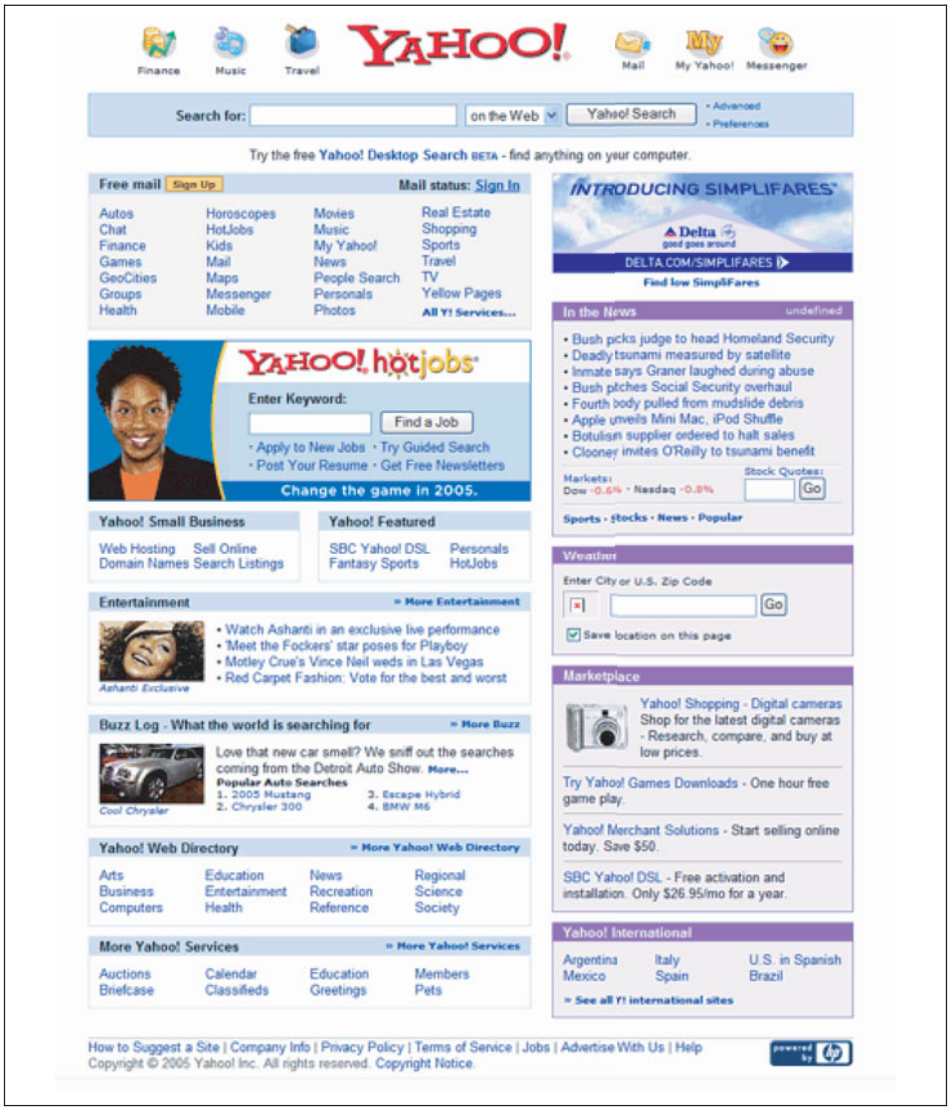
Yahoo! had been actively acquiring companies since 2002. Some of the companies acquired by Yahoo! were Flickr, Konfabulator, Upcoming.org,[26] Del.icio.us,[27] and Webjay.[28] Konfabulator was a widget[29] engine, Upcoming.org was a social event calendar, Del.icio.us was a bookmarking site, and Webjay, a music playlist service. Yahoo! launched Yahoo! 360°, a social networking service. However, many of these acquisitions could not be integrated with the company's operations. Though all these were part of Yahoo!, a user had to log in separately for accessing each of the services (see **Exhibit 6** for some of Yahoo!'s acquisitions over the years).

Yahoo!'s problems were compounded by the company's complex matrix organization structure with overlapping responsibilities, which slowed down the decision-making process. Many

EXHIBIT 4
Home Page in 1996: Yahoo!, Inc.

SOURCE: *www.cnet.com. Reproduced with permission of Yahoo! Inc. © 2011 Yahoo! Inc. YAHOO! and the YAHOO! logo are registered trademarks of Yahoo! Inc.*

EXHIBIT 5
Home Page in 2004: Yahoo!, Inc.



SOURCE: *www.cnet.com. Reproduced with permission of Yahoo! Inc. © 2011 Yahoo! Inc. YAHOO! and the YAHOO! logo are registered trademarks of Yahoo! Inc.*

new employees in the company were of the view that the company's top-down approach did not encourage creativity. There was little cooperation between the different teams in the company. According to one of the media buyers, even the search and display teams in Yahoo! did not communicate with each other. He complained, "Their organization is set up in such a way that we could spend 50 million dollars in search, and not be recognized at all by the display people."[30]

Yahoo! had planned to acquire several companies with the objective of boosting its presence in the emerging social networking market. But it failed in these attempts. The company's existing sites were overrun by the competition. Yahoo!'s plans to acquire Facebook[31] did not meet with success as Facebook backed out of the deal, and YouTube,[32] which Yahoo! was planning to acquire, was acquired by Google. Nor did the company's plan to create original content meet with success. Yahoo! brought in several high-profile executives like Lloyd Brown from ABC Television Entertainment, as the head of Media group, Neil Budde from the *Wall Street Journal* Online, and David Katz from CBS Television. Yahoo! planned to produce television-style programs,

EXHIBIT 6
Acquisitions: Yahoo!, Inc.

Year	Acquired Company
2002	Hotjobs
	Inktomi
2003	Overture
2004	3721 Internet Assistant
	Kelkoo
	Oddpost
	The All-Seeing Eye
	MusicMatch
	Stata Lab Inc
	WUF Networks
2005	Verdisoft
	Ludicorp Research (Flickr)
	Stadeon
	TeRespondo
	Dialpad
	blo.gs
	Konfabulator
	Alibaba
	Upcoming.org
	Whereonearth
	del.icio.us
2006	Searchfox
	Meedio
	Gmarket
	Jumpcut.com
	Adlnterax
	Right Media
	Kenet Works
	bix.com
	Wretch

Compiled from various sources.

including sitcoms and talk shows for the Internet audience. Within a year, in March 2006, Yahoo! announced that it was scaling back these efforts. The content development was not going as planned, and the entertainment unit suffered from the same problems. The employment listings of Yahoo!, Hotjobs, could not withstand the competition from other employment sites like Monster and Careerbuilder. David A. Utter, staff writer covering technology and business for webpronews.com said, "Declining ad sales in the finance and automotive markets, a delayed launch of new contextual ad service, and splashy acquisitions by Google have left Yahoo! feeling like the last grape in a wine press."[33]

According to Nick Blunden, client services director, Profero,[34] "Yahoo! has lost some of the magic that propelled it into the digital stratosphere in its heyday. While there is no single explanation for this, its quest for growth appears to have undermined the sense of purpose and identity that drove its success. Just a few years ago, Yahoo!'s services seemed to be clustered around themes of communication, content, and commerce and it was renowned for its innovation in these areas. Today, it appears to be a much looser collection of services that are united by the Yahoo! name."[35]

In July 2006, when Semel announced that the launch of Panama would be delayed by three months, the stock took a beating and fell by 22% on a single day. The price dropped from

EXHIBIT 7
Quarterly Income Statement (September 2005–September 2006): Yahoo!, Inc. (Dollar amounts in millions)

Quarter Ending	Sep 30, 06	Jun 30, 06	Mar 31, 06	Sep 30, 05
Total Revenue	$1,580.32	$1,575.84	$1,567.05	$1,329.93
Cost of Revenue	681.12	645.77	657.94	520.24
Gross Profit	**899.20**	**930.07**	**909.11**	**809.69**
Selling, General, Admin. Expenses	462.00	457.75	459.46	343.44
Research & Development	202.09	208.74	217.58	141.62
Others	32.77	34.00	30.86	54.57
Total Operating Expense	**$1,377.98**	**$1,346.26**	**$1,365.84**	**$1,059.87**
Operating Income	**$202.34**	**$229.58**	**$201.21**	**$270.06**
Net Income	**$158.52**	**$164.33**	**$159.86**	**$253.77**

US$32.24 to US$25.24. When Yahoo!'s third quarter results were announced on October 12, 2006, profits were down by 38% as compared to third quarter of 2005 (see **Exhibit 7** for quarter-wise revenue and net income details of Yahoo!). At that time, Semel realized that Yahoo! needed to improve its search advertising capability in order to take advantage of growing revenues from that category. One of the founding executives of Yahoo!, Ellen Siminoff, said, "A lot of people (at Yahoo!) feel abused by the outside world and its perception of the company. They have missed a few quarters this year, they have lowered expectations, they were late in delivering Panama, and so they're in the penalty box with Wall Street."[36]

In October 2006, the *New York Times* published an article titled, "Yahoo!'s growth being eroded by new rivals" in which it was written that the company was slow in negotiating with other companies. The article particularly referred to Google's acquisition of YouTube. It was said that in spite of being the most popular website, Yahoo! had suffered setbacks in advertising, both search related and display advertising. The article quoted David Cohen, senior vice president, Universal McCann,[37] saying that many clients were opting for new sites. He said, "Yahoo! has lost the favor it enjoyed a year or two ago. There are more players in town, and the others are closing the gap relative to the things Yahoo! is good at."[38] The article said Yahoo! was late in launching new products, many of its products did not perform up to expectations, and the company was said to be demanding and inconsistent in carrying out negotiations. The new advertising upgrade was blamed for the delay in developing other products.

Yahoo! was said to be competing with established players like CNN in news, ESPN in Sports, Microsoft in e-mail, AOL in instant messaging, Google in Search, and MySpace in social networking. Tim Hanlon, senior vice president, Denuo,[39] said, "It's hard to figure out what they want to be when they grow up, even though they are grown up now. Are they a content company? Are they a service company? Or are they a portal to other things? You ask three people and you may get three different answers."[40]

After the article was published, Brad Garlinghouse, senior vice president, Communications and Communities Products at Yahoo!, sent an internal memo to some of the employees. The memo compared Yahoo!'s activities and investments to a thinly spread layer of peanut butter, as Yahoo! was involved in several activities without focus on any particular activity. The memo was leaked to the press and was published in the *Wall Street Journal*. The analogy with peanut butter led to journalists and industry insiders dubbing the memo "The Peanut Butter Manifesto."

In "The Peanut Butter Manifesto," Garlinghouse wrote that Yahoo! needed to reduce its workforce by 15–20% by eliminating the unit structure through which the company had spread its attention over several products and services and by decentralizing the matrix structure of the organization. Restructuring Yahoo! was necessary to eliminate the existing bureaucracies. Pointing out that different units in the company lacked coordination and were

competing with each other, Garlinghouse recommended a major revamp in the corporate structure. According to the *Wall Street Journal*, Garlinghouse's memo was circulated among the top brass of Yahoo!.

According to Garlinghouse, Yahoo! did not have a particular focus or strategy and was trying to cater to all the customer segments. He felt that the company should focus on a few key areas like video, mobile, and social networking. The memo mentioned that there were several competing silos existing in the company, such as Yahoo! Music Engine (YME)[41] and Musicmatch, Yahoo! Photos and Flickr, Del.icio.us and Myweb, Messenger Plug-ins and Sidebar widgets, (see **Exhibit 8** for a note on services offered by Yahoo!), which were targeted at the same customers (see **Exhibit 9** for excerpts from "The Peanut Butter Manifesto"). According to Allen Weiner, an analyst from Gartner, "Yahoo! is by no means out of the game, but [it's time] to execute on a more tightly focused vision. That's what's missing. Garlinghouse is right in saying there are way too many people doing way too many things."[42]

EXHIBIT 8
Services Offered by Yahoo!

YME or Yahoo! Music Jukebox is a free music player released in 2005. The features include CD burning, CD ripping, transfer of music to portable devices, playlist creation, music subscription, etc. Several plug-ins are also provided with Yahoo! Music Jukebox.

Musicmatch is an audio player used to manage a digital audio library. The features include CD ripping, CD playback, Internet audio, and an online music store. Musicmatch was acquired by Yahoo! in October 2004.

Yahoo! Photos is the photo sharing service provided by Yahoo!. Through this service, Yahoo! users can store photos with a jpeg or jpg extension. The users can create their individual albums, categorize the photos, and can publish the albums for others to see. An uploader tool is provided through which photos can be dragged from the computer and dropped to Yahoo! Photos. Using the other services, users can order prints, create calendars or personal stamps. Pictures stored in Yahoo! Photos can be shared through Yahoo! 360°, displayed on Yahoo! Pages, and used through Yahoo! Messenger.

Flickr is an online community platform that is popular for its photo sharing service and is widely used as a photo repository. Flickr was launched by Canada-based Ludicorp in February 2004. In March 2005, Yahoo! acquired Ludicorp.

My Web was launched in June 2005 and is a social bookmarking site, which allows users to save the cached copy of their favorite Web pages. These pages are saved to the users' personal "My Web." Users can access these Web pages any time and can conduct searches through these pages. Users can save their Yahoo! search results to My Web through Yahoo! toolbar.

Del.icio.us is social bookmarking Web site that allows the users to store, share, and discover Web bookmarks. This Web site was launched in 2003 and Yahoo! acquired it in December 2005. Del.icio.us uses non-hierarchical keyword categorization, with which users can tag bookmarks with any keyword. Most of the content on the Web site is viewable, and users can mark some bookmarks as private.

Yahoo! Widgets bring the updated view of the favorite services of the users to the desktop. Widget refers to an interface element through which the computer and the user interact. Yahoo! has more than 4,000 desktop widgets, with which several tasks can be performed; these include tracking information of the browsing history, weather widget, which downloads the weather forecasts from the selected place, digital clock widget, which shows the time and has an alarm facility, stock ticker widget, which shows updated stock prices, etc.

Messenger Plug-ins provide easy access to the user's favorite content. Some of the popular plug-ins include eBay plug-in, which displays the listings and bids on eBay, and Calendar plug-in, which allows users to view calendars. Other plug-ins allow users to listen to music, send invites, plan events, and view the blogs and photos of friends.

EXHIBIT 9
Excerpts from 'Peanut Butter Manifesto'

We lack a focused, cohesive vision for our company. We want to do everything and be everything – to everyone. We've known this for years, talk about it incessantly, but do nothing to fundamentally address it. We are scared to be left out. We are reactive instead of charting an unwavering course. We are separated into silos that far too frequently don't talk to each other. And when we do talk, it isn't to collaborate on a clearly focused strategy, but rather to argue and fight about ownership, strategies, and tactics.

Our inclination and proclivity to repeatedly hire leaders from outside the company results in disparate visions of what winning looks like—rather than a leadership team rallying around a single cohesive strategy.

I've heard our strategy described as spreading peanut butter across the myriad opportunities that continue to evolve in the online world. The result: a thin layer of investment spread across everything we do and thus we focus on nothing in particular.

We lack clarity of ownership and accountability. The most painful manifestation of this is the massive redundancy that exists throughout the organization. We now operate in an organizational structure—admittedly created with the best of intentions—that has become overly bureaucratic. For far too many employees, there is another person with dramatically similar and overlapping responsibilities. This slows us down and burdens the company with unnecessary costs.

Equally problematic, at what point in the organization does someone really OWN the success of their product or service or feature? Product, marketing, engineering, corporate strategy, financial operations . . . there are so many people in charge (or believe that they are in charge) that it's not clear if anyone is in charge. This forces decisions to be pushed up—rather than down. It forces decisions by committee or consensus and discourages the innovators from breaking the mold . . . thinking outside the box.

We lack decisiveness. Combine a lack of focus with unclear ownership, and the result is that decisions are either made or are made when it is already too late. Without a clear and focused vision, and without complete clarity of ownership, we lack a macro perspective to guide our decisions and visibility into who should make those decisions. We are repeatedly stymied by challenging and hairy decisions. We are held hostage by our analysis paralysis.

We have awesome assets. Nearly every media and communications company is painfully jealous of our position. We have the largest audience, they are highly engaged and our brand is synonymous with the Internet.

Independent of specific proposals of what this reorganization should look like, two key principles must be represented:

Blow up the matrix. Empower a new generation and model of General Managers to be true general managers, Product, marketing, user experience & design, engineering, business development & operations all report into a small number of focused General Managers. Leave no doubt as to where accountability lies.

Kill the redundancies. Align a set of new BUs so that they are not competing against each other. Search focuses on search. Social media aligns with community and communications. No competing owners for Video, Photos, etc. And Front Page becomes Switzerland. This will be a delicate exercise – decentralization can create inefficiencies, but I believe we can find the right balance.

My motivation for this memo is the adamant belief that, as before, we have a tremendous opportunity ahead. I don't pretend that I have the only available answers, but we need to get the discussion going; change is needed and it is needed soon. We can be a stronger and faster company—a company with a clearer vision and clearer ownership and clearer accountability.

We may have fallen down, but the race is a marathon and not a sprint. I don't pretend that this will be easy. It will take courage, conviction, insight, and tremendous commitment. I very much—look forward to the challenge.

SOURCE: *Yahoo! Memo: The 'Peanut Butter Manifesto,' The Wall Street Journal, November 18, 2006.*

The Reorganization Program

On December 5, 2006, Semel announced the reorganization of Yahoo! and major changes in its executive team. Semel announced, "Yahoo! is now entering what I call its third phase—focused on customers. We're seeing the competitive and advertising landscapes evolve yet again and today we announced the realignment that we believe will let Yahoo! capture the major growth opportunities ahead."[43]

Though it was widely speculated that Yahoo!'s announcement of reorganization was prompted by the leaked memo, the company denied this and said that reorganization was already in the process. According to Semel, "Now, I know what you're thinking—this is all about peanut butter. Actually, we've been orchestrating this plan for a number of months as we envisioned the next phase of growth for the Internet. Following our third quarter results, I very openly discussed that we were going to become more focused and bring about change."[44] (see **Exhibit 10** for key objectives of Yahoo!'s reorganization).

The reorganization aimed at making Yahoo! leaner, more nimble, and responsive to customers. Through the reorganization, the company planned to align its operations with the key customer segments of audiences, advertisers, and publishers and capture the emerging growth opportunities especially on the Internet, and become more customer-focused with the support of technology. Yahoo! was reorganized around three groups, with two groups, the Audience Group, and the Advertising & Publishing Group, focusing on the customer. The third group, Technology Group, aimed at strengthening the technology function in the company. The heads of the three groups reported directly to Semel.

The **Audience Group's** main focus was on creating user experiences and at the same time, generating value for the advertisers. The group was a result of the merger of seven existing product groups in the company, and was created to maintain a better focus on the customer. According to Yahoo!, the focus of the Audience Group was to "enhance its existing products in search, media, communities and communications; build social media environment across Yahoo!; open more opportunities for users to take advantage of Yahoo! tools and services off network and through mobile and digital devices; and pursue growth opportunities in emerging international markets."[45] The Audience Group focused on different services offered by Yahoo!, which included search, e-mail, messenger, e-commerce, music, and video. Through reorganization, Yahoo! aimed to bring coherence to the wide array of services it provided. The creation of the Audience Group was expected to transform the company into a social media provider and help it bring in the content that was relevant to the audience.

EXHIBIT 10
Key Objectives of Reorganization

Expand customer-centric culture and capabilities. Yahoo! will develop rich experiences for each audience segment and deliver solutions to meet the needs of all advertisers and publishers worldwide. Yahoo! will organize its services around audience segments and advertising customers, rather than around products.

Create leading social media environments. Yahoo! will leverage its strong positions in community, communications, search, as well as media content across its global network to create leading social media environments, which will encourage every user on the Yahoo! network to participate in the consumption and publishing of information, and knowledge through tagging, reviewing, sharing of images and audio, and other social media activities.

Lead in next-generation advertising platforms. Yahoo! will extend its industry-leading breadth of offerings to give the most diverse array of advertisers, from large brand marketers to local merchants, every opportunity to connect with audiences on and off Yahoo!

Drive organizational effectiveness and scale. Yahoo! will recruit and retain the best industry talent and focus its resources on high-impact, network-wide platforms to help capture the most significant long-term growth opportunities.

The **Advertising & Publisher Group's** main task was to manage Yahoo!'s advertising content, build a large audience in association with Yahoo! partner publishers, and create a global advertising network on and off Yahoo! sites. The group's aim was to transform the way in which the advertisers connected with their target audience and provide them with more value. Susan L. Decker, who was heading Yahoo! Marketplaces business unit, took over the revamped advertising unit, while continuing to function as the CFO until a new CFO was recruited. The group, with the aim of building a global advertising network, was created combining several existing units, including a search marketing unit, publishing unit, and media sales and graphical advertising unit. The group was created to serve the customer in major customer segments such as large advertisers, large adverting agencies, businesses of small and medium size, resellers, and publishers.

The Advertising & Publisher Group was organized around three functions, which were demand channels, supply channels, and marketing products (see **Exhibit 11** for more about divisions in Advertising & Publishing Group).

The **Technology Group** was headed by Farzad Nazem, chief technology officer (CTO) of Yahoo!. This group was responsible for integrated product development, and the Platform & Infrastructure sub-groups were a part of the Technology Group. The group aimed at achieving integration within product development teams. Through this group, Yahoo! wanted to channel its investment toward global platforms with high impact and scalability. Leveraging on the investments in communities to create technology and advertising platforms, Yahoo! aimed at expanding the advertising network and remaining focused on product development. With the

EXHIBIT 11
Divisions in Advertising & Publishing Group

DEMAND CHANNELS (MARKETING SOLUTIONS)
Yahoo!'s demand channels were organized into the Direct Sales Channel and the Online Channel, based on the advertisers. The direct sales channel catered to the advertisers who interacted directly with the company while the online channel was targeted at self-service advertisers, who used online services.

SUPPLY CHANNELS (YAHOO! PUBLISHER NETWORK)
This channel catered to publishing customers, and was responsible for display and display based ad networks, by securing ad inventory from different Yahoo! and non-Yahoo! sites. Yahoo! planned to offer its advertising customers a wide range of marketing products and also high quality customers through this channel.

MARKETING PRODUCTS DIVISION
The marketing products division connected the demand and supply channels, by connecting the marketing offers from demand channels with ad inventory generated by different Yahoo! channels. This division was responsible for developing products and marketplaces that would offer effectiveness for advertising customers and monetization for publishing customers. The division comprised search and listing marketplaces, and display marketplaces. These marketplaces were supported by project management, and engineering teams.

LOCAL MARKETS & COMMERCE DIVISION
This division, formerly known as Marketplaces, was brought under the Advertising & Publishing Group. This included shopping, travel, autos, hotjobs, personals, and real estate.

STRATEGIC MARKETING & MAJOR INITIATIVES
The main task of this division was to work closely with other divisions in the Advertising & Publishing group, and bring in a unified marketing strategy and customer and market segments.

SOURCE: *Adapted from E-Mail Titled 'Update on APG Organization' Sent by Susan Decker to all Yahoo! Employees on February 14, 2007. Retrieved from www.techcrunch.com.*

centralized technology group, it was expected that users could access all the services provided by Yahoo! products with a single Yahoo! e-mail account. According to Justin Port, analyst with Merrill Lynch,[46] "The elevated status of the Technology Group underscores management's commitment to improving product innovation."[47]

As part of the reorganization program, which was expected to be completed by the end of March 2007, three executives—Dan Rosensweig, COO, Lloyd Braun, head Media Group, and John Marcom, senior vice president, International Operations, resigned from the organization during the first quarter 2007. The reorganization program also led to a new mission statement for Yahoo!: "to connect people to their passions, their communities, and the world's knowledge." Analyst opined that the new mission statement signified the fact that Yahoo! had put people at the center of their strategy. They said that by restructuring, Yahoo! was changing its focus to eliminate redundancies and increase accountability and decision making and emerge as a customer-focused organization.

The Road Ahead

Yahoo!'s reorganization was expected to eliminate the bureaucracy that had crept into the company over a period of time. After the reorganization was announced, the company's stock price fell by 2% to US$26.86. Industry experts were of the view that it was high time Yahoo! was reorganized, as the previous reorganization[48] was done about five years back (see **Exhibit 12** for Yahoo!'s stock price chart).

EXHIBIT 12

Stock Price Chart (April 2002–March 2007): Yahoo!, Inc.

SOURCE: *www.bigchart.com*

Another strategy that Yahoo! adopted was "Brand Universe" through which it planned to develop sites dedicated to high-profile entertainment brands, including television shows like *Lost*[49] and *The Office*,[50] video games like Halo[51] and The Sims,[52] and movies like *Harry Potter*.[53] Through Brand Universe, Yahoo! planned to link entertainment content across different Yahoo! services and Web sites. All the entertainment partners would also be informed about the traffic their content was attracting, the reach of the brands, and other such details. The fact the YouTube was planning to include short advertisements before each video clip was expected to boost Yahoo!'s ability to attract visitors, as visitors who wished to skip the advertisements would opt for other alternatives, such as Yahoo!.

To spruce up Yahoo! News, which was accessed by 34 million unique users every month as of 2006, Yahoo! launched video content in association with CBS owned stations. Yahoo! News served over 60 million video streams per month as of February 2007.

In November 2006, Yahoo! entered into an agreement with a consortium of nine companies, representing more than 170 newspapers in the United States. The consortium included Hearst Newspapers, MediaNews Group, Cox Newspapers, Lee Enterprises, Journal Register, and EW Scripps. As per the agreement, the newspapers started using Yahoo! HotJobs from December 2006 onward. Both the parties were expected to benefit from the deal, as Yahoo! would get regional exposure while advertisements from local newspapers would acquire a wider reach. Over a period of time, other content such as local news and advertisements were also planned to be included.

In the first week of December 2006, Yahoo! released a mobile social networking service called Mixd with which customers could coordinate outings and meetings with friends using text messages and photo messages. The activities were simultaneously posted on the Web page. The service was targeted at young users of 18–25 years of age and Yahoo! started marketing the service in some university campuses in the United States.

According to industry experts, Yahoo! was on the right path in proposing a restructuring plan; however, what mattered most was how the plan was executed. They said Yahoo! should be careful in executing the reorganization program. Analysts also opined that the reorganization might take some time to show results. Meanwhile, Yahoo! had to face competition not only from existing players but also from new ones, which were making their presence felt in the market. Yahoo! needed to generate more revenues from social media and user-generated content. There were suggestions that Yahoo! could consider a merger with AOL or Microsoft, as neither of these companies was strong in search engine technology. Any such deal, according to analysts, would help Yahoo! compete with Google effectively.

Analysts were of the opinion that as Yahoo! was one of the most popular sites attracting millions of unique visitors, through Panama, it could increase the number of clicks on the ads, and thus generate more revenues. Commenting on Panama, Paul Kedrosky, partner, Ventures West,[54] said, "It doesn't have to be as good as Google, Yahoo! has this bazooka. It stomps Google in page views. And Yahoo! is still the king of audience. There is a huge upside for them."[55] Yahoo! also had another advantage of having specialized sites like Yahoo! Finance, Yahoo! Real Estate, Yahoo! Tech, etc. through which it could charge a premium from advertisers who were targeting a particular set of audience.

Yahoo! itself considered 2007 to be a year of transition with many challenges to face. Analysts too were of the same view, as Imran Khan, analyst at JP Morgan Chase,[56] said, "The coming year will be challenging, in terms of numbers. The management change doesn't fix the problem. There are lots of new competitors and Yahoo! is not as well-positioned in search as Google."[57]

Within one month of the launch of Panama, Yahoo! experienced better click-through rates for sponsored search ads. comScore[58] analyzed the click-through rates before and after the launch of Panama, by dividing the total clicks on sponsored search ads by the total search ads. It was found that after the launch of Panama, in the first week the click-through ads grew by 5% compared to a week before the launch. By the second week, the click-through rates rose to 9%.

Some analysts were of the view that Yahoo!'s wide array of service had attracted millions of users to the portal. These users did not need to go to different Web sites to access different services. They said that Yahoo! should continue to provide all these services, and should only look at revamping its advertising services and better search engine.

Industry experts also opined that the problem lay not with Yahoo! but with advertisers, who were highly optimistic about search-based advertising and its prospects. They felt that Yahoo!, even if it came up with the best in terms of search engine, would not be able to compete with Google. Yahoo! remained strong in financial forums and community sites like Flickr and del.icio.us. Instead of trying to attract customers from Google, Yahoo! could target competitors like MSN and ask.com, opined an analyst from Standard & Poor's.

However, industry experts remained optimistic about Yahoo!'s future prospects after its reorganization and the launch of Panama. According to comScore Media Networks, Google's share in the Internet search market in the United States stood at 47.5% in January 2007, while Yahoo!'s share was at 28.1%. According to Nick Blunden, client services director, Profero, "Despite recent challenges, the Yahoo! business has a lot going for it. The brand is a fantastic asset with extraordinary levels of awareness. Yahoo! also retains one of the single biggest online audiences worldwide. Finally, while it may not have outright market leadership in all of its services, many of them are extremely competitive."[59]

NOTES

1. "Yahoo! Re-Aligns Organization to More Effectively Focus on Key Customer Segments and Capture Future Growth Opportunities," Yahoo! press release, December 05, 2006.
2. "Yahoo! Shake-up to Take on Rivals," http://news.bbc.co.uk, December 6, 2006.
3. RBC Capital Markets, a part of Royal Bank of Canada, is a corporate and investment bank providing a wide range of services and products catering to institutions, corporations, and governments across the world.
4. U.S.-based Google has specialized in Internet search and online advertising. As of December 2006, the company's revenue was at US$10.604 billion and net income stood at US$3.077 billion.
5. Adwords allows advertisers to place their advertisements on Google's search results. It provides pay-per-click advertising and site-targeted advertising for text and banner ads.
6. The Susquehanna Financial Group is a part of Susquehanna International Group of companies of SIG, which comprises several trading and investment related companies. The company's primary focus is on investment banking, trading, and institutional sales and research.
7. Paul R. La Monica, "Yahoo! Thumps Google on Wall Street," CNNMoney.com, March 05, 2007.
8. Dow Jones & Company-owned *Wall Street Journal* is a daily newspaper published from New York, with a circulation of around 2 million per day.
9. Global Crown Capital is a San Francisco–based boutique investment firm, specializing in objective and actionable research, institutional sales and trading, hedge funds, wealth management, and asset management.
10. Michele Gershberg, "Yahoo!'s New Ad System Could Boost Growth: Analysts," Reuters, January 24, 2007.
11. Yahoo! is the abbreviation for Yet Another Hierarchical Officious Oracle.
12. Banner advertisements appear on Web pages within various Yahoo! channels. Hypertext links were embedded in each banner advertisement to give users instant access to the advertiser's Web site, to obtain additional information, or to purchase products and services.
13. Promotional sponsorships were typically focused on a particular event, such as sweepstakes. The merchant sponsorship icon advertised products. Users had to click on the icon to complete a transaction.
14. Direct marketing revenues came through e-mail campaigns targeted at Yahoo!'s registered users who had indicated their willingness to receive such promotions.
15. While tracking the number of visitors on a Web site, unique visitor refers to a person who visits a Web site more than once within a specified period of time. Through the use of software, a company can track and count Web site visitors and can also distinguish between visitors who visit the site only once and unique visitors who return to the site.
16. Pioneered by Overture, the "paid search" advertising model is also know as "pay-per-click" model. In this model, Overture provided an auction room for online advertisers, whose bidding determined how prominently their link will be displayed. Overture then provided a list of these advertisers to customers, including Yahoo! and shared with them the advertising revenues once the visitors on Yahoo!'s site clicked on those ads.
17. Based in California, Inktomi is a pioneer in Web search technology. The company was a leading provider of Web search and paid inclusion services.
18. Yahoo! renamed Overture as Yahoo! Search Marketing.
19. Web Crawler, also known as Spider, is a program that visits Web sites and reads their pages and other information in order to create entries for search engine index.
20. Yahoo! Slurp, a Web crawler, is used to put content into the search engine. Yahoo! Slurp was based on the Web search technology of Inktomi.
21. Robert Hof, "Five Steps to Get Yahoo! Back on Track," BusinessWeek, December 7, 2006.

22. eBay.com is an online auction and shopping Web site managed by the U.S.-based Internet company eBay Inc. In 2005, eBay Inc. recorded revenues of US$4.55 billion.
23. MySpace is a social networking Web site and its content includes personal profiles, blogs, groups, photos, music, and videos. The parent company of MySpace is News Corporation.
24. Flickr is a photo sharing Web site and an online community platform. It was launched by Ludicorp in 2004. In March 2005, Yahoo! acquired Ludicorp and Flickr.
25. Jeremy Caplan, Jeffrey Ressner, "How Yahoo! Aims to Reboot," Time South Pacific, February 12, 2007.
26. Upcoming.org is a social events calendar that used user-generated content and social media to capture event information. Yahoo! acquired the company in October 2005.
27. Del.icio.us is a social bookmarking Web service used for storing and sharing bookmarks. Yahoo! acquired the company in December 2005.
28. Webjay is a Web-based playlist service, containing links to audio files on the Web. Yahoo! acquired Webjay in January 2006.
29. Widget is a small application with a graphical interface component that can be used to perform a variety of functions like search, photo, and mapping services. Widgets run on the desktops without use of browsers. Through the widgets the portals can draw visitors directly from the desktop.
30. Gavin O'Malley, "Madison Ave: Yahoo! Overhaul Might Fall Short," Online Media Daily, December 8, 2006.
31. Facebook is a social networking Web site, focused on college and university students. It is the seventh most visited Web site in the United States and boasts of several photo uploads. The Web site was founded by Mark Zuckerberg, a sophomore at Harvard University, in February 2004.
32. YouTube is a video sharing Web site that allows the users to upload, share, and view video clips, and was founded in February 2005. YouTube was named *Time* Magazine's Invention of the Year for 2006. In October 2006, Google acquired YouTube for US$1.65 billion.
33. David A. Utter, "Yahoo! Pressed from All Sides," www.webpronews.com, October 13, 2006.
34. London-based Profero, is a digital marketing agency that provides services like Web development, search and affiliate marketing, advertising, media planning and buying, and relationship marketing. The clients of Profero include CNN, Sky TV, BBC World, Black & Decker, Singapore Airlines, Johnson & Johnson, and Merrill Lynch.
35. Gemma Charles, "Yahoo!" Marketing, January 3, 2007.
36. Jeremy Caplan, Jeffrey Ressner, "How Yahoo! Aims to Reboot," *Time South Pacific*, February 12, 2007.
37. Universal McCann was created in 1999 through the consolidation of the media operations of McCann Erickson. The company's worldwide billings stood at US$13 billion in 2006.
38. Saul Hansell, "Yahoo!'s Growth Being Eroded by New Rivals," *New York Times*, October 11, 2006.
39. Denuo is the media futures consulting arm of the Publicis Groupe, the fourth largest communications company. The company has a presence in 104 countries across the world. Denuo is actively involved in strategic consulting, ventures and partnerships, and catalyst and activation.
40. Saul Hansell, "Yahoo!'s Growth Being Eroded by New Rivals," *New York Times*, October 11, 2006.
41. In August 2006, the Yahoo! Music Engine was renamed Yahoo! Music Jukebox.
42. "Peanut Butter Sticks to Yahoo!," www.infoworld.com, November 27, 2006.
43. Terry Semel, "Taking Yahoo! Forward," http://yodel.yahoo.com, December 5, 2006.
44. Terry Semel, "Taking Yahoo! Forward," http://yodel.yahoo.com, December 5, 2006.
45. "Yahoo! Re-Aligns Organization to More Effectively Focus on Key Customer Segments and Capture Future Growth Opportunities," Yahoo! press release, December 5, 2006.
46. Merrill Lynch is one of the world's leading financial management and advisory companies, with offices in 36 countries and territories and total client assets of approximately $1.8 trillion. The services provided by Merrill Lynch, its subsidiaries, and affiliates are capital market services, investment banking and advisory, wealth management, asset management, and insurance and banking. In 2005, the company recorded revenue of US$47.78 billion and net income of US$5.046 billion.
47. Robert Hof, "Five Steps to Get Yahoo! Back on Track," BusinessWeek, December 7, 2006.
48. A detailed description of Yahoo!'s previous reorganization is covered in the ICMR case study, "reviving Yahoo!—Strategies that Turned the Leading Internet Portal Around," Reference No. BSTR064 (www.icmr.icfai.org).
49. *Lost* is a highly popular television drama series aired on ABC network in the United States. *Lost* has won several awards, including Golden Globes and Emmys. The series depicts the lives of plane crash survivors.
50. After the success of the BBC series *The Office* in the UK, NBC created a U.S. version of the popular show, which premiered in March 2005. This situation comedy series is set in the office of a paper supply company.
51. Halo is a video game from Bungie Studios, which featured Master Chief, a soldier with superhuman strength and technologically advanced armor.
52. Sims is a computer game published by Maxis. It is a strategic life simulation computer game, about the day-to-day activities of people in a household in fictional SimCity. The game was released in February 2000 and went on to become one of the best selling PC games.
53. *Harry Potter* is a series of novels written by JK Rowling, featuring Harry Potter and his fight against an evil wizard. The movies based on the Harry Potter series were distributed by Warner Brothers.
54. Ventures West is a Canada-based Venture Capital partner, which has invested in more than 150 companies.
55. Catherine Holahan, "Why Yahoo!'s Panama Won't be Enough," *BusinessWeek*, December 26, 2006.
56. Incorporated in 1800s by Janius S. Morgan, a merchant banker, JP Morgan is one of the leading banks in the United States. In 2001, JP Morgan merged with Chase Manhattan to create the second largest bank in the United States. In July 2004, JP Morgan bought Bank One Corporation, which created an entity with combined assets of US$1.1 trillion. In 2006, the revenues of the merged entity stood at US$61.437 billion and net income at US$14.44 billion.
57. Jefferson Graham, "Yahoo!'s Shake-up: Too Little, Too Late?" *USA Today*, December 7, 2006.
58. comScore provided marketing and data services to several large businesses and is one of the leading Internet market research companies. comScore provides insight into the online behavior of consumers by tracking the Internet data on the surveyed computers.
59. Gemma Charles, "Yahoo!" Marketing, January 3, 2007.

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CASE 14

TiVo Inc.:

TIVO VS. CABLE AND SATELLITE DVR; CAN TIVO SURVIVE?

Alan N. Hoffman, Rendy Halim, Rangki Son, and Suzanne Wong

Background

"With TiVo, TV fits into your busy life, NOT the other way around."

THE HISTORY OF TELEVISION BEGAN IN 1939 with the purpose of providing people with entertainment in their homes. It was followed in 1950 by the invention of the remote control—an extraordinarily successful invention. Forty years later, two creative Silicon Valley veterans, Mike Ramsey and Jim Barton, invented an innovative and advanced technological development, a digital video recorder (DVR) called the TiVo. They created TiVo to be "TV Your Way." According to its founders, "With TiVo, TV fits into your busy life, NOT the other way around."

By now, many people may have heard of TiVo from its being mentioned in popular TV shows and motion pictures. Even Oprah Winfrey wondered in the September 2005 issue of her "O" magazine: "Why can't life be like TiVo?" Unfortunately, even by 2007, not very many people knew what TiVo did or how it did it.

Once Upon a TiVo …

Pioneered by Mike Ramsay and Jim Barton, TiVo redefined television entertainment by delivering the promise of technologies that up until then had only been promised. Incorporated in Delaware and originally named Teleworld, TiVo was founded as a company on August 4, 1997. As proposed, the original concept was to create a home network–based multimedia

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server in which content to "thin" clients would be streamed throughout the home. In order to market such a product, a solid software foundation was first needed. The device had to operate flawlessly, be reliable, and handle power failure gracefully for the users. At the time, both founders were working at Silicon Graphics (SGI) and were very much involved in the entertainment industry. Jim Barton was then involved with an on-demand video system and was the executive sponsor of an effort to port an open source system called Linux to the SGI Indy workstation. Mike Ramsay was responsible at that time for products that created movies' special effects for such companies as ILM and Pixar. These two SGI veterans thought Linux software would serve TiVo well as its operating system foundation. The hardware was designed solely by TiVo Inc., but manufactured by other companies, including Philips, Sony, Hughes, Pioneer, Toshiba, and Humax. They created a product that was interactive, delivering a service that allowed people to assume greater control of their television viewing.

From the Server Room to the Living Room

Departing slightly from their original idea to create a home network device, the founders developed the idea of recording digitized video on a computer hard drive. Inside TiVo's Silicon Valley headquarters in Alviso, California, the founders created what they called a "fantasy living room" that they hoped would serve as a prototype for 100 million living rooms across North America. The fantasy living room was composed of an oval coffee table and a comfortable chair. The only objects on the table surface were a telephone and TiVo's distinctive peanut-shaped remote control. The sofa and chairs all faced an entertainment center containing a big-screen television that was linked to several TiVo boxes.

At the time, Ramsey and Barton both knew it would be fun to exploit and develop their concept into an actual product with a promising future—the dream of most start-ups companies. In the early days of the company, Mike Ramsay commented that they used to think: "Wow, you know, you can pause live television—isn't that a cool thing?" Jim Barton worked to store a live TV signal on a computer and play it back. That was the start of TiVo—an invention to create the world's first interactive entertainment network, in which the luxury of entertainment and control was firmly in the viewers' own hands. TiVo shipped its first unit on March 31, 1999. Since that date was considered to be a blue moon (second full moon in a month), the engineering staff code-named TiVo's first version as the "Blue Moon." Both Jim Barton and Mike Ramsay were excited by the market introduction of their innovative product. Teleworld was renamed TiVo in July 1999.

TiVo Acclamation

With the success of on-demand programs and online streaming catering to people's viewing habits, many people have found the DVR to be an essential part of their digital home entertainment center. Salespeople at big box retailers, such as Best Buy, Circuit City, Target, and Wal-Mart, often referred to any DVR as a TiVo even though TiVo was not the only DVR on the market. Both ReplayTV and TiVo launched DVRs at the 1999 Consumer Electronics Show in Las Vegas. ReplayTV won the "Best of Show" award in the video category and was later acquired by SonicBlue and D&M Holdings. Surprisingly, ReplayTV's version of the DVR failed to attract customers. TiVo, in contrast, became widely known and succeeded at becoming the only stand-alone DVR company in the industry. According to the research firm, Forrester, TiVo's brand trust among regular users scored 4.2 (out of 5 possible), while its brand potential among aspiring users scored an "A" with 11.1 million potential users.

Spending approximately 13 months to develop the first TiVo unit, the company found the wait to be worthwhile. TiVo received an Emmy award in August 19, 2006, in recognition of

TiVo's providing innovative and interactive services that greatly enhanced television viewing. Other finalists for that Emmy award included AOL Music on Demand, CNN Enhanced, and DirecTV Interactive Sports. TiVo established a well-known brand that became extremely popular among fiercely loyal customers and even non-users. Becoming a cult-like product, TiVo was transformed into a verb. Celebrities like Regis Philbin would say "TiVo it," meaning to record a program. A working wife, who had an important business dinner meeting that night and was rushing through the door, would ask her husband: "Could you TiVo Desperate Housewives for me tonight, dear?" On the other hand, TiVo felt that this verb transformation might jeopardize the TiVo brand and associate its products with the generic DVR. People might say, "I want two TiVos," when they meant DVRs. Nevertheless, thanks to TiVo's product acceptance, TiVo became publicly listed September 30, 1999, on the NASDAQ at an opening price of $16 per share with 5.5 million shares being offered. On its way to the IPO (initial product offering), TiVo established one of the most rapid adoption rates in the history of consumer electronics. According to the April 2007 issue of *PC World*, TiVo was third on its list of 50 best technology products of all time.

As of 2007, TiVo was available in four countries: the United States, United Kingdom, Canada, and Taiwan. Although TiVo was not yet being sold in Australia, New Zealand, Netherlands, or South Africa, its technology was informally being modified by end users so it could fit their systems. Nevertheless, TiVo had not generated a profit since its launching in 1997. Considered to be the best DVR system in use by a variety of top-notch publications, such as *Business Week*, *New York Times*, and *Popular Science*, TiVo achieved a 3 million subscriber milestone on February 18, 2005. TiVo's subscribers included well-known loyal subscribers, such as Oprah Winfrey, Brad Pitt, Regis Philbin, and entrepreneur Craig Newmark (the owner of *Craigslist*). TiVo's mission was simple: Connect consumers to the digital entertainment they want, where and when they want it.

The Brain Inside the Box

"It's not TiVo unless it's a TiVo"

The Surf and Turf

As people's daily life became busier and they demanded more convenience in watching TV, digital video recorders became the tool to satisfy that need. DVRs were far easier to use than VCRs (video cassette recorders) and provided more capabilities, such as replaying a program in slow motion or temporarily putting a TV program on hold while answering the door or making a phone call. The DVR platform created a massive opportunity for TiVo to continue developing creative and sophisticated applications, features, and services. As a digital video recorder, TiVo used Linux-based software to allow users to capture any TV program and record it onto internal hard disk storage for later viewing.

The TiVo device also allowed users to watch their programs without having to watch the commercials. This feature was very attractive to consumers, but not to television networks and advertising agencies. However, unlike ReplayTV, which allowed users to automatically skip advertisements (causing it to be the target of several lawsuits from ad agencies and TV networks), TiVo took a different approach. As with a VCR, viewers using TiVo could either watch the commercials or fast-forward through them.

With an inventive advertising feature, TiVo created a business opportunity. Knowing that advertising could be a source of revenue, TiVo's management tested a "pop-up" feature. While recording or watching a program, advertisements popped up at the bottom of the TV screen. If a customer was interested in any of these advertisements, he/she had the ability to

click to get more information about the product being advertised. People thus had the choice to get advertisers' information or not, depending on their interests. "Product Watch" let users choose the products, services, or even brands that interested them and would automatically find and deliver the requested products straight to a viewer's list. Surprisingly, during the 2002 Super Bowl, TiVo tracked the viewing patterns of 10,000 of its subscribers and found that TiVo's instant replay feature was used more on certain commercials, notably the Pepsi ad with Britney Spears, than on the game itself. TiVo included 70 "showcase" advertising campaigns in its TiVo platforms for companies such as Acura, Best Buy, BMW, Buick, Cadillac, Charles Schwab, Coca-Cola, Dell, General Motors, GMC, New Line Cinema, Nissan, Pioneer, Porsche, and Target.

In addition to the features previously mentioned, there was much more for users to experience. A "Season Pass Manager" avoided conflicts, such as one recording canceling another. A "Wish List" platform allowed viewers to store their search accordingly to their interests, such as actor, keyword, director, etc. No other company had yet been able to match these two TiVo recording features. In addition, the easy-to-use remote control with its distinctive "Thumbs Up and Down" feature allowed users to rate the shows they had watched so that TiVo could assist and provide users with programs similar to what they had rated positively. This feature also provided TiVo with some useful market research data. The remote control had won design awards from the Consumer Electronics Association. Jakob Nielsen, a technology consultant of the Nielsen Norman Group, called the oversize yellow pause button in the middle of the remote "the most beautiful pause button I've ever seen." Steve Wozniak, the co-founder of Apple Computer, stated that "TiVo adjusts to my tastes. Its remote has been the most ergonomic and easy to use one that I have had encountered in many years."

"TiVoToGo," a feature launched in January 2005, allowed users to connect their TiVo to a computer with an Internet or a home network, transferring recorded shows from TiVo boxes to users' PCs. Through a software program developed with Sonic, customers were able to edit and save their TiVo files. In August 2005, TiVo released a software program that allowed customers to transfer MPEG2 video files from their PC to their TiVo boxes in order to play the video on the TiVo DVR.

The TiVoToGo feature included TiVo's "Central Online," which allowed users to schedule recordings on its Web site, "MultiRoom Viewing," and allowed them to transfer recordings between TiVo units in multiple rooms, download any programs in any format into the TiVo box and transfer them into other devices, such as an IPOD, laptop, or other mobile device, such as cellular phones. This provided users with the opportunity to view recordings anytime and anywhere the users desired. With various partnerships that TiVo had established regarding third-party network content, viewers could access weather, traffic condition, and even purchase a last-minute movie ticket at Fandango.com. Viewers could also use "Amazon Unbox" to buy or rent the latest movies and TV shows that would be downloaded into the TiVo box. By early 2007, Amazon had 1,500 TiVo-compatible movies listed for rent and 2,300 available for purchase.

"Behind The Box"—The Hardware Anatomy of TiVo 101

TiVo units can be installed fairly easily because they had been designed for anyone to install and operate. Parts that went into the device and its internal architecture had been made less complex. An online self-installation guide with step-by-step pictured instruction was used to complete the installation request. It was possible, however, to have professional installation service through a retailer, such as Best Buy or a customer's cable provider.

In reality, TiVo was simply a cable box with a hard drive that provided the ability to record using a fancy user interface. The main idea at the beginning was to free people from a TV network's schedule. With TiVo, the viewer could watch programs at any time using features such as pause, rewind, fast forward, and slow motion.

TiVo's model Series 2 was supported with USB ports that had been integrated into the TiVo system to support network adapters that included wired Ethernet and WiFi capabilities. It received its signal from the cable or satellite box. It also provided the ability to record a program over-the-air. The next generation, TiVo Series 3, had been built with two internal cable-ready tuners and supported a single external cable or satellite box. As a result, the Series 3 TiVo provided the ability to record two shows at once, unlike other DVRs available at that time. Moreover, the latest version of the TiVo box had a 10/1000 Ethernet connection port and a SATA port which could support external storage hardware. It also had an HDMI plug, which provided an interface between any compatible digital audio/video source, such as a DVD player, a PC, or a video game system. With the new Series 3 TiVo box, customers no longer needed their cable box. Some recent models contained DVD-R/RW drives that transferred recordings from the TiVo box to a DVD disc.

TiVo hardware could also work alone as a normal DVR. It was thus possible for TiVo users to keep the TiVo hardware but cancel their TiVo subscription. This, of course, could seriously damage TiVo's revenue stream.

What the Hack!

Where technology was involved, there were always incentives for hackers to challenge the system. Some people hacked into the TiVo boxes to improve the service and expand its recording and/or storage capacity. Others tried to make TiVo available in countries where TiVo was not currently available. In the latest version of TiVo, improved encryption of the hardware and software made it more difficult for people to hack the systems.

The Tivo Operation – Behind the Scenes …

". . . .and I never miss an episode. TiVo takes care of the details"

Manufacturing and Supply Chain

TiVo outsourced the manufacturing of its products to third-party manufacturers. This outsourcing extended from prototyping to volume manufacturing and included activities such as material procurement, final assembly, test, quality control, and shipment to distribution centers. The majority of the company's products were assembled in Mexico. TiVo's primary distribution center was operated on an outsourced basis in Texas.

Several consumer electronics manufacturers, including Toshiba, Humax, and Pioneer, manufactured and distributed TiVo-enabled stand-alone DVRs during the last three years. The company also engaged contract manufacturers to build TiVo-enabled stand-alone DVRs.

The components that made up TiVo's products were purchased from various vendors, including key suppliers such as Broadcom, which supplied microprocessors. Some of TiVo's components, including microprocessors, chassis, remote controls, and certain discrete components were currently supplied by sole source suppliers.

Marketing

Feel the Buzzzzzz—Hail Thy TiVo

When it came to new technology, penetrating existing consumer markets was usually difficult. Customers were often slower to embrace new product than forecasters predicted and opted to choose an older and more familiar technology, like that used by VCRs. TiVo founder

Mike Ramsay would often get upset in TiVo's early days when someone said, "Oh, that's just like a VCR." He would then retort, "No, no, no, no, no. It's much more than a VCR. It does this. . . . It does that. . . . Let's personalize it and all that stuff." At that point, Ramsey found that it became difficult to describe what TiVo actually was, leading to a five- to 10-minute conversation instead of a 30-second TiVo advertisement.

In its early years, TiVo tried the standard approach of explaining the product via ads—resulting in a series of stumbles in marketing. Millions of dollars spent on advertising did not help consumers understand what TiVo actually did. A customer claimed, "I personally remember seeing TiVo ads on TV before I even knew what a TiVo was, and it took seven years for me to finally see one 'in the flesh.'"

What made TiVo DVRs different from generic DVRs could not be grasped by most people by simply seeing the differences listed in **Exhibit 1**. As a true "experience good," it could only be felt and experienced by using the product itself. TiVo's interface was vastly superior to that used by most competitive DVRs. According to Gartner analyst Van Baker, "For cable and satellite DVRs, the interface stinks. They do a really bad job of it." Once people used a TiVo, many told others about the product and how it had improved their enjoyment of television. According to a survey reported on the TiVo Web site, 98% of users said that they could not live without their TiVo.

Between 1999 and 2000, TiVo's subscriptions increased by 86%. In addition to capitalizing on its thousands of customer evangelists to move the product into the mainstream, TiVo's word-of-mouth strategy focused on celebrity endorsements and television show product placement. The firm began giving its product away to such celebrities as Oprah Winfrey, Jay Leno, Sarah Michelle Gellar, Rosie O'Donnell, and Drew Bledsoe, turning them into high-profile members of the cult of satisfied TiVo users. Total subscriptions increased from 3.3 million (1.2 million TiVo-owned plus 2.1 million DirecTV-controlled) in early 2005 to 4.4 million (1.7 million TiVo-owned plus 2.7 million DirecTV-controlled) at end-2006.

Sales and marketing expenses consisted primarily of employee salaries and related expenses, media advertising (including print, online, radio, and television), public relations activities, special promotions, trade shows, and the production of product-related items, including collateral and videos. Advertising expenses were $15.9 million, $10.4 million, and $16.1 million for the fiscal years ended January 31, 2007, 2006, and 2005, respectively.

The TiVo-owned churn rate per month was 1.0% for the fiscal year ended January 31, 2007, compared to .9% and .7% for the fiscal years ended January 31, 2006, and 2005, respectively. The churn rate measure was composed of total TiVo-owned subscription cancellations during a period divided by the average TiVo-owned subscriptions for that period divided by the number of months in the period. Management anticipated that the TiVo-owned churn rate per month would increase in future periods as a result of increased competition in the marketplace, competitive pricing issues, the growing importance of offering competitive service features such as high definition television recording capabilities, and increased churn from product lifetime subscriptions. TiVo had previously offered lifetime service subscriptions to initially attract people to purchase TiVo DVRs, but was no longer making this offer. It had been replaced by one- to three-year service contracts containing monthly fees.

Subscription acquisition costs (SAC) totaled $267 million in 2006, $196 in 2005, and $182 in 2004. Management defined SAC as the company's total acquisition costs for a given period divided by TiVo-owned subscription gross additions for the same period. Total acquisition costs were the sum of sales and marketing expenses, rebates, revenue share, and other payments to channel, minus hardware gross margin (defined as hardware revenues less cost of hardware revenues). This included all fixed costs, including headcount-related expense, such as stock-based compensation, marketing not directly associated with subscription acquisition, operating expenses for the advertising sales business, and allocations.

EXHIBIT 1
TiVo's Product Specifications+

	TiVo Series2™ Boxes	Leading Cable Service DVR*	Satellite DVR**	DIRECTV DVR with TiVo©
Record from multiple sources	**Yes** combine satellite, cable, or antenna, depending on product	**No** Digital cable only	**No** Satellite only	**No** DIRECTV only
Easy search: Find shows by title, actor, genre, or keyword	Yes	Titles only browsing only	title, subject, and actor only	Yes
Online scheduling: Schedule recordings from the Internet	Yes	No	No	No
Dual Tuner: Record 2 shows at once[1]	Yes	Yes	Yes	Yes
Movie and TV Downloads: Purchase or rent 1000s of movies and television shows from Amazon Unbox and have them delivered directly to your television.[2]	Yes	No	No	No
Home Movie Sharing: Edit, enhance, and send movies and photo slideshows from your One True Media account to any broadband connected TiVo box.[3]	Yes	No	No	No
Online services: Yahoo! weather, traffic & digital photos, Internet Radio from Live365, Podcasts, & movie tickets from Fandango	Yes	Limited	Limited	No
Built-In Ethernet: Broadband-ready right out of the box—connecting to your home network is a snap[4]	Yes	No	No	No
TiVoToGo transfers to mobile devices: Transfer shows to your favorite portable devices, laptop, or burn them to DVD.[3]	Yes	No	No	No
Home media features: Digital photos, digital music, and more	Yes	No	No	No
Transfer shows between boxes: Record shows on one TV and watch them on another.[3, 5]	Yes	No	No	No

Notes:

*Leading cable services compared to Time Warner/Cox Communications Explorer® 8000™ DVR and Comcast DVR
**Leading satellite services compared to DISH Network 625 DVR
[1]On theTiVo® Series2™ DT DVR, you can record 2 basic cable channels, or one basic cable and one digital cable channel, at once.
[2]Requires broadband cable modem or DSL connection
[3]Requires your TiVo box to be connected to a home network wirelessly or via Ethernet
[4]Available on the new TiVo® Series2™ DT DVR and the TiVo® Series3™ DMR
[5]In order to burn TiVoToGo transfers to DVD you will need to purchase software from Roxio/Sonic Solutions.

SOURCE: http://www.TiVo.com/1.0.chart.asp.

(Continued)

EXHIBIT 1
(Continued)

Multiroom Solutions

	Diego/Maxi	Motorola	Scientific-Atlanta	EchoStar	TiVo	Microsoft
Main DVR	Cable DVR[1]	Cable DVR[2]	Cable DVR[3]	Satellite DVR[4]	Tivo box	Media Center PC
Set-top box on additional TV(s)	IP terminal	Cable box[5]	Cable box	None Analog	TiVo box	Xbox 360
How boxes share content	IP	IP	Digital broadcast	broadcast	IP[5]	IP
Physical connection	Coax	Coax	Coax	Coax	Home network	Home network
Features available on additional TVs:						
Play back recorded programs	✓	✓	✓	✓	✓	✓
Record programs	✓	✓		✓	✓	✓
Pause programs	✓	✓		✓	✓	✓
View Internet content	✓	x			✓	✓
View personal digital content	x	x			✓	✓

Notes:
[1]New product specifically designed for multiroom use
[2]Standard cable DVR plus modifications for multiroom use
[3]Requires additional IP dongle on standard digital set-top box
[4]Available, but operators have not yet deployed
[5]Requires transferring files from one TiVo box to the other

SOURCE: *Forrester Research Inc., 2006.*

The Market Research Team

The need to create an emotional connection between people and its products was significant to TiVo's success. The company's market research team was considered key to management's understanding of TiVo's target market. The market research team was supported in its work by Lieberman Research Worldwide and Nielsen Media Research. With Lieberman, the first DVR-based panel was established in August 2002. Internally, TiVo had built a mechanism in its system that sent detailed information back to TiVo on the viewing habits of its customers. TiVo also fully embraced the viewing community with community and hackers programs so that the TiVo research team better understood users' viewing needs and wants.

Financial

Fast Forward or Rewind TiVo's Stock?

Upon going public with an IPO in 1999, TiVo's stock was listed with an initial price of $16 per share. TiVo's stock soon reached $78.75, the highest price in the stock's history. After the initial enthusiasm, TiVo's stock price eventually dropped by 2002 to a low of $2.25, the lowest in its history. TiVo's stock price began to rise in 2003 when the FCC Chairman Michael Powell announced that he used TiVo—claiming TiVo was a "God's Machine"—and when the White House Press Secretary Ari Fleischer admitted to being a loyal user of TiVo. In mid-2003,

when TiVo achieved one million subscribers, its stock price jumped to $14.00 per share. It then fell to a low of $3.50 per share resulting from the resignation of its founder-CEO, Mike Ramsay. With a new CEO in place, TiVo reached the 3 million subscriber milestone by mid-2005. The stock fluctuated around $6–$8 per share in 2006 and closed at $5.35 on January 31, 2007, the end of the company's 2006 fiscal year. The company followed a policy of declaring no cash dividends.

Since its founding, the company had incurred significant losses and has had substantial negative cash flow. During the 2006 fiscal year ended January 31, 2007, the firm had a net loss of $47.8 million. TiVo had a positive cash flow of $3.8 million for the year of 2006 thanks to $64.5 million raised from the sale of 8.2 million shares of its common stock in September, 2006. (See **Exhibits 2 and 3** for financial statements.)

EXHIBIT 2

Consolidated Statements of Operations: TiVo, Inc. (Dollar amounts in thousands, except per share and share amounts)

Year Ending January 31	2007	2006	2005
Revenues			
Service and technology revenues (includes $6,805 from related parties for the fiscal year ended January 31, 2005)	$ 217,985	$ 170,859	$ 115,476
Hardware revenues	88,740	72,093	111,275
Rebates, revenue share, and other payments to channel	(48,136)	(47,027)	(54,696)
Net revenues	258,589	195,925	172,055
Cost of revenues			
Cost of service and technology revenues (1)	60,177	34,961	35,935
Cost of hardware revenues	112,212	86,817	120,323
Total cost of revenues	172,389	121,778	156,258
Gross margin	86,200	74,147	15,797
Research and development (1)	50,728	41,087	37,634
Sales and marketing (1) (includes $1,100 from related parties for the fiscal year ended January 31, 2005)	42,955	35,047	37,367
General and administrative (1)	44,813	38,018	16,593
Total operating expenses	138,496	114,152	91,594
Loss from operations	(52,296)	(40,005)	(75,797)
Interest income	4,767	3,084	1,548
Interest expense and other	(173)	(14)	(5,459)
Loss before income taxes	(47,702)	(36,935)	(79,708)
Provision for income taxes	(52)	(64)	(134)
Net loss	$ (47,754)	$ (36,999)	$ (79,842)
Net loss per common share – basic and diluted	$ (0.53)	$ (0.44)	$ (0.99)
Weighted average common shares used to calculate basic and diluted net loss per share	89,864,237	83,682,575	80,263,980
(1) Includes stock-based compensation expense (benefit) as follows:			
Cost of service and technology revenues	$ 1,490	$ —	$ —
Research and development	5,596	(85)	754
Sales and marketing	1,649	55	302
General and administrative	5,977	415	—

EXHIBIT 3

Consolidated Balance Sheets: TiVo, Inc. (Dollar amounts in thousands, except share amounts)

Year Ending	January 31, 2007	January 31, 2006
ASSETS		
CURRENT ASSETS		
Cash and cash equivalents	$ 89,079	$ 85,298
Short-term investments	39,686	18,915
Accounts receivable, net of allowance for doubtful accounts of $271 and $56	20,641	20,111
Inventories	29,980	10,939
Prepaid expenses and other, current	3,071	8,744
Total current assets	182,457	144,007
LONG-TERM ASSETS		
Property and equipment, net	11,706	9,448
Purchased technology, capitalized software, and intangible assets, net	16,769	5,206
Prepaid expenses and other, long-term	1,018	347
Total long-term assets	29,493	15,001
Total assets	$ 211,950	$ 159,008
Liabilities' and Stockholders' Equity (Deficit) Liabilities		
Current Liabilities		
Accounts payable	$ 37,127	$ 24,050
Accrued liabilities	36,542	37,449
Deferred revenue, current	64,872	57,902
Total current liabilities	138,541	119,401
Long-Term Liabilities		
Deferred revenue, long-term	54,851	67,575
Deferred rent and other	1,562	1,404
Total long-term liabilities	56,413	68,979
Total liabilities	194,954	188,380
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY (DEFICIT)		
Preferred stock, par value $0.001:		
Authorized shares are 10,000,000; Issued and outstanding shares – none	—	—
Common stock, par value $0.001:		
Authorized shares are 150,000,000; Issued shares are 97,311,986 and 85,376,191, respectively and outstanding shares are 97,231,483 and 85,376,191, respectively	97	85
Additional paid-in capital	759,314	667,055
Deferred compensation	—	(2,421)
Accumulated deficit	(741,845)	(694,091)
Less: Treasury stock, at cost – 80,503 shares	(570)	—
Total stockholders' equity (deficit)	16,996	(29,372)
Total liabilities and stockholders' equity (deficit)	$ 211,950	$ 159,008

Decontructing TiVo

Since its founding in 1997, TiVo had accumulated $741.8 million in losses. Looking at TiVo's revenue and cost structures in **Exhibit 2**, the company recorded its revenues under service and technology and hardware. In order to become profitable, the company's management needed to find ways to increase revenues faster than costs increased. In terms of service and technology revenues, for example, TiVo needed to know the actual value of TiVo-owned subscribers and not just TiVo's partnership subscribers of DirectTV and Comcast. Deconstructing the value of just this one particular matter led to larger questions, which included, how long did a TiVo subscriber remain a subscriber, how much did each of them they pay, how much were they willing to pay, and how much advertising revenue did users produce for every tag they clicked? Moreover, how long and how could TiVo maintain its subscribers as TiVo-owned subscribers?

TiVo's hardware revenue was subject to a chicken and egg problem. If management dropped the price of TiVo hardware, more people would buy TiVo DVRs and subscribe to the TiVo service. It would then, however, be selling hardware at a significant loss. Even though rebates were offered, TiVo's management in 2007 had not yet found a price point that would attract a significantly larger number of buyers. In early 2007, TiVo offered three types of boxes depending on the hours of programming storage capacity. These ranged from an 80-hour TiVo Series 2 to a 300-hour TiVo Series 3. The basic TiVo Series 2 box of 80 hours and 180 hours had a one-time price of $99.99 and $199.99, respectively, while the TiVo Series 3 box with 300-hour storage capacity was priced at $799.99. TiVo customers then needed to pay a monthly subscription fee to obtain TiVo service.

The company had been a heavy user of mail-in rebates, which were reflected on the income statement as negative revenue. According to *Business Week*, $5 million in additional positive revenue was recognized because nearly half of TiVo's 100,000 new subscribers failed to apply for a $100 rebate. This slippage, known to marketers as the "shoebox effect," was very helpful to TiVo's revenues.

Research and Development

The word "interactive" was the slogan of R&D. TiVo's R&D team made sure that they built TiVo from the user's perspective and his/her viewing habits. There was a TiVo Forum composed of communication through TiVo Community.com and TiVo hackers. In this forum, criticism was allowed and even encouraged, so long as it was constructive and helped TiVo to grow. Ideas generated through this forum helped TiVo's R&D team and developers to be innovative by continuous adjusting to people's ever-changing lifestyles. TiVo's management was also concerned with how TiVo's platform could be used inappropriately by children. As a result, TiVo had collaborated with parents to build a new feature called the TiVo Parental Zone that allowed parents to control what their kids watched. TiVo protected its users' privacy by storing personal information on a computer behind its "firewall" in a secure location and by restricting the number of employees internally who could access this data.

In its early years, TiVo's R&D staff consisted only of contract-based engineers. As the company grew, management expanded its R&D team to consist of a diverse and creative group of on-staff engineers. It had an R&D policy stating that new benefits must extend people's existing behaviors. The design team had a very detailed list of steps to follow to ensure the fit of TiVo products to user needs. As an example of TiVo's meticulous product design process, TiVo created a remote control that combined personalization and interconnectivity. TiVo's remote had a feature of thumbs up and down to be clicked by users to rate shows so that the TiVo box would know what to record. In addition, TiVo enabled Braille on its remote for vision-impaired

users. Other R&D processes included product testing and development of software and platforms, integration of software to satellite systems, and product integration, such as with the DVD burner and TiVo recorder. Besides developing its main products, the TiVo R&D team also designed platforms and technology that could be used with other products to enhance the performance of TiVo's main products, such as the ability to connect with computers, other home theater technologies, and especially with cable and satellites.

Since competition was increasing in the DVR industry, TiVo's management decided to patent the company's advanced software and technology platforms. TiVo licensed its TiVo-ToGo software to chip maker AMD and digital media software, such as Sonic Solutions, to Microsoft in order to enable video playback on pocket PCs and smart phones. As of end-2006, TiVo had 85 patents granted and 117 patents pending, including both domestic and foreign patents. TiVo licensed its patents through several of its trusted partners, including Sony, Toshiba, Pioneer, and Direct TV. TiVo's management believed that licensing its technology to third parties was an excellent revenue generator.

Although total company employee headcount had increased by approximately 7% in fiscal year 2007, the company increased the number of its regular, temporary, and part-time employees engaged in research and development by 9% from a total of 264 to 288 as of January 31, 2007, compared to January 31, 2006.

Corporate Governance

Top Management

In its early years, TiVo's top management had been personally involved in operations and marketing. Founder Mike Ramsay often made overseas trips to conduct meetings and seminars with consumer electronics manufacturers. This was as an attempt to convince the manufacturers to embed TiVo's software into their products. In order to make sure everything went well and accordingly to plan, Ramsey focused on maintaining partnerships. He would rarely be in his office. He would instead be on the road talking to companies that could help TiVo build software and subscribers. During his tenure as TiVo's CEO, Ramsey did commit a number of managerial errors. For example, instead of re-doubling marketing efforts when two distribution contracts were lost during 2001, he laid-off 80 employees (approx 25% of its workforce at the time) in April, 2001, plus 40 more employees (approx 20% of its remaining workforce) in the following October. Ramsay was an engineer and knew how to be creative and build great machines, but didn't truly understand the industry or how to manage the company's growth. By 2005, the company was drowning in red ink and its future was in doubt. As a result, Mike Ramsay was forced to resign in July 2005 and a change of CEO was implemented by the board of directors. The board hired as TiVo's new CEO the former president of NBC Cable, Tom Rogers.

Mike Ramsey continued to serve on TiVo's board of directors after his resignation. The board agreed to a transition agreement with Ramsey in which Ramsay agreed to provide services to TiVo that included assistance with executive transition matters, service as chairman of the Technology Advisory Committee of TiVo's Board and TiVo's beta test program, cooperation with existing or future litigation, and the provision of other advice and assistance that fell within Mr. Ramsay's knowledge and expertise in exchange for a salary of $100,000 annually plus stock options. Ramsay's transition employment agreement had been renewed and was in effect through September 8, 2007.

In early 2007, TiVo's current top managers were:

Thomas S. Rogers, 52, was appointed by TiVo's board to serve as a director in September 2003 and was named president and chief executive officer of TiVo, effective July 1, 2005. From 2004 until July 2005, he served as the senior operating executive for media and

entertainment for Cerberus Capital Management, a large private equity firm. From October 1999 until April 2003, Rogers had been chairman and CEO of Primedia Inc., a print, video, and online media company. From January 1987 until October 1999, Rogers held positions with National Broadcast Company Inc., including president of NBC Cable and executive vice president. Rogers held a B.A. degree in Government from Wesleyan University and a J.D. degree from Columbia Law School. In 2006, he earned $504,583 in salary and $294,521 in bonuses plus $4,282,000 in stock options tied to long-term performance.

Steve Sordello, 37, was named senior vice president and chief financial officer in August 2006. He replaced David H. Courtney, who had resigned from TiVo in April 2006. Prior to joining TiVo, Sordello had served as executive vice president and chief financial officer at Ask Jeeves from April 2001 until October 2005, when the company was acquired by IAC/InterActiveCorp. Prior to Ask Jeeves, Sordello held senior positions at Adobe Systems Inc. and Syntex Corporation. Sordello held a B.S. degree in Management/Accounting and an M.B.A. degree from Santa Clara University.

James Barton, 48, was a co-founder of TiVo and served as TiVo's vice president of Research and Development, chief technical officer and director since the company's inception to January 2004, and was currently chief technical officer and senior vice president. From June 1996 to August 1997, Barton had been president and chief executive officer of Network Age Software Inc., a company that he founded to develop software products targeted at managed electronic distribution. From November 1994 to May 1996, Barton had served as chief technical officer of Interactive Digital Solutions Company, a joint venture of Silicon Graphics Incorporated (SGI) and AT&T Network Systems created to develop interactive television systems. From June 1993 to November 1994, Barton had served as vice president and general manager of the Media Systems Division of SGI. From January 1990 to May 1991, Barton had served as vice president and general manager for the Systems Software Division of Silicon Graphics. Prior to joining SGI, Barton held technical and management positions with Hewlett-Packard and Bell Laboratories. Mr. Barton held a B.S. degree in Electrical Engineering and an M.S. degree in Computer Science from the University of Colorado at Boulder. In 2006, Barton earned $275,000 in salary and $133,100 in bonuses plus $151,694 in stock options tied to long-term performance.

Jeffrey Klugman, 46, was named senior vice president and general manager, Service Provider and Media and Advertising Services Division, in April 2005. Klugman had served as vice president of Technology Licensing from December 2001 until February 2004 and vice president, TiVo Platform Business, from February 2004 until April 2005. Prior to joining TiVo, Klugman had been CEO of PointsBeyond.com, an Internet-portal start-up focused on outdoor activities and adventures. In 1999, Klugman served as vice president of Marketing and Business Development for Quantum Corporation's Consumer Electronics Business Unit. Klugman held a B.S. degree in engineering from Carnegie Mellon University and an M.B.A. degree from the Stanford Business School. In 2006, he earned $225,000 in salary and $108,419 in bonuses plus $238,315 in stock options tied to long-term performance.

Mark A. Roberts, 46, was named senior vice president of Consumer Products and Operations in October 2005 responsible for Consumer Products Engineering and Product Strategy, Manufacturing, Distribution, Call Center, Service Operations, Information Technology, Facilities and Broadcast Center Operations. He had served as senior vice president of Engineering since December 2002 until October 2005 and chief information officer of TiVo from March 1999 until December 2002. Prior to joining TiVo, he had served as vice president of Information Technology at Acuson Corporation, a medical ultrasound company,

from March 1996 to March 1999. From July 1990 to March 1996, Roberts was director of Information Systems at SGI. Roberts held a B.S. degree in Economics from Santa Clara University. In 2006, he earned $255,000 in salary and $148,717 in bonuses plus $222,395 in stock options based on long-term performance.

Matthew Zinn, 42, was named senior vice president, general counsel, secretary, and chief privacy officer in April 2006. Zinn had served as vice president, general counsel, and chief privacy officer since July 2000 and as corporate secretary since November 2003. From May 1998 to July 2000, Zinn was the senior attorney, Broadband Law and Policy, for the MediaOne Group, a global communications company. From August 1995 to May 1998, Zinn served as corporate counsel for Continental Cablevision, the third largest cable television operator in the United States. From November 1993 to August 1995, he was an associate with the Washington, D.C., law firm of Cole, Raywid & Braverman, where he represented cable operators in federal, state, and local matters. Zinn held a B.A. degree in Political Science from the University of Vermont and a J.D. degree from the George Washington University National Law Center.

Nancy Kato, 52, was named senior vice president of Human Resources in April 2006. Kato had served as vice president, Human Resources, since January 2005. From January 2003 to January 2005 Kato was vice president of Global Compensation at Hewlett-Packard. From December 2000 to October 2002 Kato was senior vice president of Human Resources for Ariba. She has also held senior roles at Compaq and Tandem. Kato held a B.S. in Health Sciences and M.A. in Education and Counseling from San Jose State University.

Joe Miller, 40, was named senior vice president, Consumer Sales and Distribution, in September 2006 and was responsible for all aspects of the company's TiVo-Owned sales and distribution efforts. Miller had served as TiVo's vice president, Consumer Sales and Distribution, from May 1999 to August 2006. Prior to joining TiVo. Miller was with U.S. Satellite Broadcasting from February 1994 to May 1999 as general manager of Retail Sales and prior to that Miller was a national sales manager for Cox Satellite Programming. Miller held a B.A. degree in Public Relations from Southwest Texas State.

Individual senior executives who owned shares of the company's stock in 2006 were: CEO Thomas Rogers, 960,816 shares (1.1% of total shares outstanding), Sr. VP & Chief Technical Officer James Barton, 1,135,928 shares (1.3% of total shares outstanding), Sr. VP & General Manager of Service Provider & Media Advertising Services Jeffrey Klugman, 115,887 shares (less than 1% of total shares outstanding), and Sr. VP of Consumer Products & Operations Mark Roberts, 151,173 shares (less than 1%).

Board of Directors

TiVo's board of directors consisted of three executives from the venture capital firms of Kleiner Perkins Caufield & Byers, Redpoint Ventures, and New Enterprise Associates, three senior executives from NBC, Coca-Cola, and Univision Communications, an independent consultant who had been CFO at Univision Communications, plus TiVo's current and past CEO, for a total of nine members of the board. The board selected Jeffrey Hinson as its ninth member on January 26, 2007, for his financial experience as an ex-CFO to join the board and serve as chairman of its audit committee. See **Exhibit 4** for a list of the members of the board of directors, their backgrounds, and committee assignments.

Individual non-management directors owned the following amounts of stock in 2006 (% of total in parentheses): Michael Ramsey, 3,020,102 shares (3.5%), David Zaslav, 3,777,151 shares (4.4%), Geoffrey Y. Yang, 2,663,295 shares (3.1%), Mark Perry, 849,063 shares (less than 1%), Randy Komisar, 333,963 shares (less than 1%), Joseph Uva, 75,000 shares (less than

EXHIBIT 4
Board of Directors: TiVo

1. Board of Directors: TiVo Inc.

Name of Director	Age	Principal Occupation	Term Expires	Director Since
Michael Ramsey[1]	56	Former Chairman of the Board & CEO, TiVo Inc.	2009	1997
Geoffrey Y. Yang[1]	47	Managing Director, Redpoint Ventures & General Partner, Institutional Ventures Partners	2009	1997
Randy Komisar[1]	51	Partner, Kleiner Perkins Caufield & Byers	2009	1998
David M. Zaslav	46	Executive Vice President, NBC & President, NBC Cable	2007	2000
Mark W. Perry	62	General Partner, New Enterprise Associates	2007	2003
Thomas S. Rogers	51	President & CEO, TiVo Inc.	2008	2003
Charles B. Fruit	59	Sr. Vice President, Chief Marketing Officer, Coca-Cola Company	2007	2004
Joseph Uva	50	CEO, Univision Communications, Inc.	2008	2004
Jeffrey Hinson[2]	51	Consultant. Past-CFO, Univision Communications Inc.	2007	2007

Notes:

[1]Elected at 2006 annual meeting.

[2]Added in January, 2007.

2. Board Committees

(as of 1/31/2007)

Audit: Hinson (Chair), Fruit, Perry
Compensation: Yang (Chair), Uva
Nominating & Governance: Komisar (Chair), Yang
Pricing: Zaslav (Chair), Perry
Technology: Ramsey (Chair), Komisar, Yang

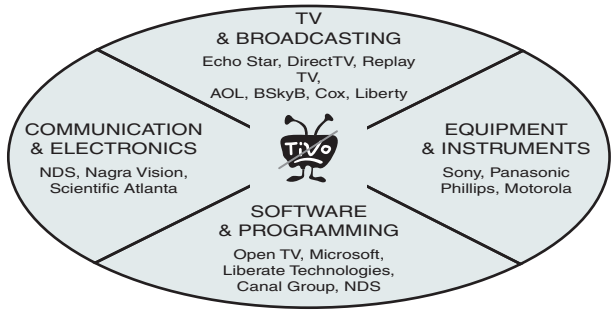
1%), and Charles Fruit, 75,000 shares (less than 1%). All executive officers and directors owned as a group 16.3% of shares outstanding. Other shareholders owning more than 5% of shares outstanding were the investment firms of FMR Corporation (8.1%) and Wellington Management (7.5%).

The TiVo board used five committees to conduct its business: audit, compensation, nominating and governance, pricing, and technology committees. Non-employee (outside) directors received an annual retainer of $15,000, plus $1,000 for each committee meeting attended. (Committee chairs receive an additional $2,000 for each committee meeting attended.) In addition, each director received stock option grants to purchase 50,000 shares when elected to the board and an additional grant to purchase 25,000 shares each year thereafter.

Human Resources

TiVo employed approximately 451 employees, including 48 in service operations, 246 in research and development, 44 in sales and marketing, and 113 in general and administration. The company also employed, from time to time, a number of temporary and part-time employees as well as consultants on a contract basis. The employees were not represented by a collective bargaining organization. The company had never experienced a work stoppage or strike and management considered employee relations to be good.

EXHIBIT 5
The Digital Video Recorder or Personal Video Recorder Market Was Located at the Convergence of Four Established Industries: TV and Broadcasting, Software and Programming, Equipment and Instruments, and Communication and Electronics.



Sleeping with Enemies

". . . So Long, TiVo! Hello DVR! . . ."

The Industry

For TiVo, the introduction of its digital video recorder was full of obstacles. The DVR was a "disruptive technology," a technology that created something new which usurped existing products and services. According to TiVo's founder Mike Ramsay, the DVR phenomenon established that "people really want to take control of television, and if you give them control, they don't want you to take it back." Although TiVo had added the software, platforms, and services that a TiVo DVR had to offer, the viewing experience was incomplete without a connection to a cable network or to satellite signals. Therefore, users who wanted a TiVo DVR needed to subscribe to the TiVo service, pay a one-time fee for a TiVo box, and subscribe to a cable or satellite provider, such as Comcast or DirecTV. Because of this requirement, the TiVo DVR had been made with a built-in cable-ready tuner for use with any external cable box or satellite receiver. TiVo had forged many alliances and sometimes even competed with cable operators and satellite networks. With cable, satellite, and electronics companies pushing to market their own DVRs, the DVR industry was expected to grow rapidly.

In terms of market share, TiVo claimed to cover the entire U.S. market (See **Exhibit 6**).

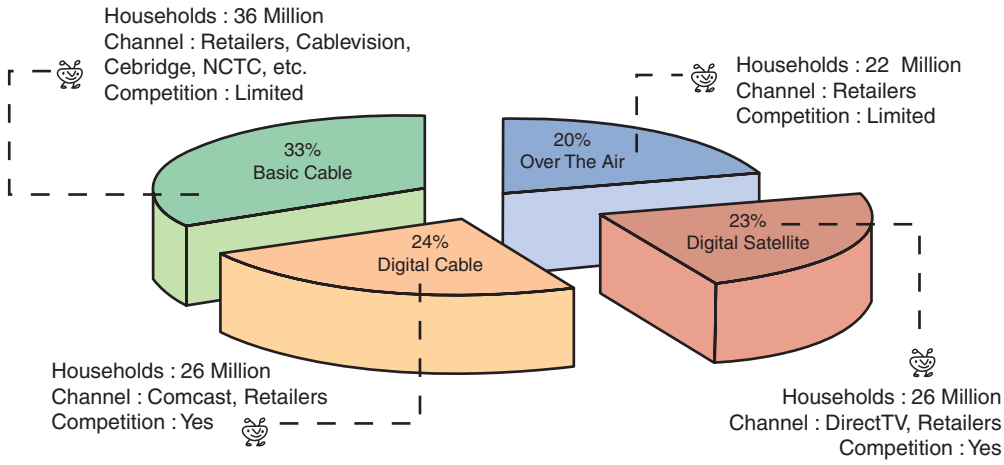
Friends or Foe?

In 2000, AOL had invested $200 million in TiVo and became the largest shareholder of the company and one of its main service partners. The AOL connection enabled TiVo to release a box that provided both TiVo's capabilities and AOL services. In addition to AOL, TiVo established other service partnerships. TiVo and Discovery Communication and NBC agreed to an $8.1 million deal in the form of advertising and promotional services. An additional $5 million was paid to NBC for promotions. TiVo also collaborated on research and development with Discover Communication, allowing TiVo to use a portion of its satellite network. AT&T supported TiVo in the marketing and selling of its service in the Boston, Denver, and Silicon Valley areas. BSkyB was the service partner for TiVo in the United Kingdom. Creative Artists Agency marketed and gave promotional support to the personal video recorder and was given in exchange 67,122 shares of TiVo's preferred stock.

Despite TiVo's many alliances, the company was faced with the difficult challenge of working with cable and satellite operators who offered their own digital video recorder-equipped

EXHIBIT 6

WE COVER the ENTIRE U.S. MARKET



SOURCE: *Natexis Bielchroeder, Inc., July 2005.*

set-top boxes. Cable operators like Time Warner Cable and Cox Communications offered built-in DVR capability in set-top boxes and provided the equipment free to subscribers. In August 2003, Echostar announced a free DVR promotion, an unprecedented move in the industry. TiVo's relatively expensive hardware could jeopardize the company's ability to compete with cable or satellite service providers that offered their own DVRs at a lower price. There were relatively few nationwide cable or satellite providers, leaving TiVo with little bargaining power. These cable/satellite providers could affect pricing of the TiVo technology because of their size and because of their ability to market their own version of a generic DVR unit to their subscription base. Although TiVo had to give a piece of its potential profits to partners, TiVo's management decided to form strategic relationships with competitors and cable companies for distribution.

DirecTV, the satellite service provider, had served as TiVo's backbone in its early years. This service partner had fueled most of TiVo's early growth. TiVo's current 4.4 million subscribers had mostly come from its partnership with DirecTV. In early 2002, subscribers to TiVo's service through DirecTV increased from 230,000 to 2.1 million, representing more than half of all DVR subscriptions. Subscription fees to Direct TV ranged from $29.99/month for 40 channels to $65.99/month for over 250 channels. Interestingly, when DirecTV first began negotiations with TiVo, the satellite provider had already been equipped with a DVR service through its partnership with Microsoft's Ultimate TV.

DirecTV decided in 2005 to develop its own DVR device in cooperation with the NDS Group. It soon informed TiVo that it would stop marketing and selling TiVo's digital recorders to its satellite TV subscribers starting in 2007. This was a serious blow to TiVo. DirecTV's DVR would cost users a $299 onetime fee, but it included unique features, such as the ability to jump to a specific scene in the program as well as allowing users to pay for downloaded pay-per-view movies only when they were being viewed. In 2006, TiVo and DirecTV reached a commercial extension agreement for three years. The agreement allowed existing DirecTV customers using the TiVo digital video recorder to continue to receive maintenance and support from DirecTV. As part of the agreement, TiVo and DirecTV agreed that they wouldn't sue each other over patent rights. Since the agreement with DirecTV was facing an expiration date in 2009, TiVo has been rushing to differentiate its product and working to make other distribution agreements.

In July 2000, Comcast, the nation's leading cable operator, agreed to a trial offering of TiVo boxes to its subscribers. TiVo's management hoped that the trial would lead to a bigger deal in which Comcast would integrate TiVo software into Comcast cable boxes. Unfortunately, Comcast balked and was unwilling to agree to this extension of the agreement. In April 2001, when another trial failed to lead to a larger deal, TiVo laid off approximately 25% of its staff. In November 2001, after AT&T Broadband had just agreed to offer TiVo DVRs to its customers, Comcast acquired the cable provider and its 14 million customers, and canceled the agreement. In 2002, cable operators such as Comcast ended up developing their own DVR boxes with makers such as Motorola and Scientific-Atlanta. Even though the DVR was similar to that offered by DirecTV, Comcast announced in March 2005 that it would offer its customers a video recorder service from TiVo and even would allow TiVo to develop its software for Comcast's DVR platform. Comcast and TiVo agreed to make TiVo's DVR service and interactive advertising capability (ad management system) available through Comcast's cable network and its set-top DVR boxes. This agreement also included that the first of their co-developed products would be available in mid- to late-2006 under the TiVo brand name.

Subscriptions to Comcast's basic or standard cable cost users $8.63 or $52.55, respectively. Adding a DVR feature cost an additional $13.94 with Comcast in addition to the TiVo subscription, which ranged from $12.95 to $16.95 per month depending on the length of the plan (from one to three years). Following this agreement with Comcast, TiVo's shares closed up nearly 75%, or $2.87 per share, to $6.70. Investment analysts were positive about the news, some upgrading TiVo's investment rating from a sell to a hold. Since DirecTV had started using a second company, NDS, to provide DVR service, the deal with Comcast put to rest some of these concerns by opening up a large new potential audience for TiVo's service. According to a TiVo filing with the SEC, TiVo received an upfront payment from Comcast for creating a new DVR that worked with Comcast's current service. TiVo also received a recurring monthly fee for each Comcast subscriber who used TiVo through Comcast.

Offering new technology-driven products, such as a DVR, was easier for satellite broadcasters because changes could be made in a central location. For cable operators, however, new technologies and products needed to be deployed gradually as the operators had different equipment in different areas.

TiVo and BellSouth FastAccess DSL recently agreed on a variety of co-marketing arrangements. With its strong presence and high level of customer satisfaction in the Southeastern United States, BellSouth could provide a DSL Internet pipeline for TiVo to send video content directly to the television. To expand program recording to a cellular phone, its latest TiVo Mobile feature, TiVo made an agreement with Verizon. The agreement brought the digital video recording pioneer's capabilities beyond its set-top-boxes and the television directly to cell phones for the first time. In terms of content, TiVo also had engaged in new partnerships with CBS Corp, Reuters Group PLC, Forbes magazine, New York Times Co., and the National Basketball Association, among others. This would make news and entertainment programs available for downloading onto TiVos. International Creative Management recommended films, television shows, and Internet videos that TiVo users could download onto their boxes. In addition, TiVo's management decided to offer amateur videos through an agreement with One True Media Inc., an Internet start-up that operated a Web service designed to help users easily edit their raw footage into quality home movies.

The TALKA TiVo

". . . Bring 'em on! We are talking the HD language now . . . Yeah!."

TiVo Series 2 DT

The company's basic DVR was its TiVo Series 2 DT unit. It included dual tuners (DT) so that a viewer could record two programs at the same time (but only one digital signal) or watch one program while recording another. Customers could choose between two versions: the basic 80-hour unit or the 180-hour unit. The selling price for an 80-hour unit with a one-year service commitment was $16.95 a month or $179 prepaid plus $99.99 for the box. The monthly service fee was reduced by $2 for each additional year on the service commitment. The Series 2 DT DVR could record from multiple sources, such as cable, satellite, or antenna. See **Exhibit 1** for product specifications.

High Definition Television

High definition (HD) was the most important new consumer electronic development in television. HD products radically increased the quality of the viewing and listening experience. High definition sets included HD TV, HD broadcasting, HD DVD, HD Radio, HD Photo, and even HD Audio.

High definition TV (HD TV) was first introduced in the United States during the 1990s. It was a digital television broadcasting system using a significantly higher resolution than the traditional formats, such as NTSC, PAL, and SECAM. The technology during the 1990s was very expensive. With increasing production levels, prices decreased and HD TV was being offered in an increasing number of televisions. As of 2007, HD TVs were being used in 24 million U.S. households. It was predicted that by 2009, high definition would replace standard definition television. With the price of computer hard drives becoming lower and the increasing availability of HD TV broadcasting, demand for the HD products was increasing rapidly. Compared to standard definition television, HD TV offered viewers greater screen clarity and smoother motion with richer, more natural colors, and surround sound.

TiVo Series 3

TiVo recently introduced the TiVo Series 3 to allow customers to record high definition television and digital cable. Since TiVo's management realized that great quality video needed to be supported by great quality audio, the company put a lot of effort in the audio development and received the certification of being the first digital media recorder to meet the THX performance standard in HD TV. THX was known to have developed the highest standard of audio—mainly the surround-sound systems in the entertainment as well as the media industry.

The new high definition TiVo Series 3, which was being sold for $799.000, had two tuners, giving it the ability to record two HD programs simultaneously while playing back a third previously recorded program. (This required two CableCARDS for dual-function capability through cable or antenna, but did not support satellite service.) Its larger storage capacity allowed it to record up to 300 hours of standard definition programming or 32 hours of high-definition programming. It also had two signal inputs and it accepted cable TV and over-the-air signals. Despite TiVo's ability to record and playback at high definition quality, a downside was its relatively high price—especially when some cable companies were offering non-HD DVRs free to their subscribers. The monthly service fee was, however, the same as that for the Series 2.

TiVo HD

The company was developing a new version of the TiVo box, which would be available for sale in 2007. The TiVo HD had most of the features of the Series 3, but would be sold for only $300. The new TiVo contained a 160 GB hard drive good for recording 180 hours of

standard-definition programming or 20 hours of high-definition programming. Both Series 3 and HD models used the same architecture and had dual tuners, two slots for CableCARDS, and the same ports. (Like the Series 3 DVR, the TiVo HD required two CableCARDS for dual-function capability through antenna or cable, but did not support satellite service.) The TiVo HD did come with a cheaper remote control and, contrasted with the Series 3 remote, was not backlit or capable of controlling other components. The monthly service fee was the same as that for the Series 2 or 3 DVRs.

HD TiVENemies

The cable operator, Comcast, did not sell DVRs, but allowed its subscribers to rent DVR boxes for $13.94 per month (in addition to their cable subscription fee). Its HD DVR boxes were manufactured by Motorola and Scientific Atlanta. Users of these DVRs were able to navigate their own preferences as they would with TiVo, except that TiVo offered better and more features built into its boxes.

The satellite operator, DirecTV, allowed subscribers to add an additional DVR subscription service for $4.99 monthly on top of the chosen monthly subscription service package to DirecTV cable channels (ranging in cost from $29.99 to $65.99 per month). DirecTV offered its subscribers the opportunity to buy a standard definition DVR for $99.99 and an HD DVR box for $299 with a $100 rebate.

Looking to the Future

As CEO Tom Rogers looked at TiVo's financial statements for the 2006 fiscal year ending January 31, 2007, he pondered TiVo's future prospects. In some ways, the future looked very promising. Approximately 16 million households had DVRs and this number was expected to increase to 56 million by 2010 according to The Carmel Group. Given its user-friendly software interface and celebrity endorsements, TiVo should be able to obtain a large piece of that growth. Although there were many versions of the generic DVR, the TiVo DVR had perceived sex appeal. TiVo had been successful in creating a unique set of technologies, products, and services that were meeting the needs of consumers, television distributors, and the advertising community. TiVo's advantages were clear:

- Compelling, easy-to-use consumer DVR offerings
- Differentiated features
- Integrated broadband and broadcast capabilities (download movies, etc.)
- Portable technology platform
- Advanced advertising and promotion solutions

The company's current strategy included a number of key elements:

- Offer an increasingly differentiated service
- Diversify our sources of revenue to include more advertising
- Integrate TiVo technology with third-party DVR platforms to provide TiVo service
- Extend and protect TiVo's intellectual property
- Promote and leverage the TiVo brand through multiple advertising and marketing channels
- Extend the TiVo product beyond the U.S. market into countries such as China and Mexico

There were also a number of challenges to consider. During the past fiscal year, the company experienced growth in its TiVo-owned subscription base and subscription revenues.

However, this subscription growth was largely offset by the loss of a portion of TiVo's DirecTV installed subscription base. Even though management decided to invest in subscription acquisition activities in an effort to expand TiVo's subscription base and promote the TiVo brand for future partnerships, TiVo-owned subscription gross additions for the fiscal year 2007 were 429,000—down 13% from fiscal year 2006. Although it was not unusual for entrepreneurial ventures to generate losses for their first few years of operation, TiVo had not earned a profit in the 10 years since it had been founded or in the eight years since it went public. It hadn't had a profitable quarter in the past two years!

As with any publicly held U.S. company, TiVo had to list risk factors that might affect its future performance. Compared to the list of risks found in the SEC Form 10-K Report of most publicly held companies, TiVo's list of risks was extremely long—over 17 pages! Some of these risk factors were:

- We face intense competition from a number of sources, which may impair our revenues, increase our subscription acquisition cost, and hinder our ability to generate new subscriptions.
- We depend upon a limited number of third parties to manufacture, distribute, and supply critical components, assemblies, and services for the DVRs that enable the TiVo service. We may not be able to operate our business if these parties do not perform their obligations.
- DVRs could be the subject of future regulations relating to copyright law or evolving industry standards and practices that could adversely impact our business.
- A significant part of our installed subscription base results from our relationship with DirecTV which we expect to decrease in the future due to DirecTV's support of a competing DVR by NDS.
- We face a number of challenges in the sale and marketing of the TiVo service and products that enable that service. Even when consumers are aware of the benefits of our products, they may not be willing to pay for them, especially when competitors under price us.
- If we are unable to create or maintain multiple revenue streams, such as licensing, advertising, audience research measurement, revenues from programmers, and electronic commerce, we may not be able to recover our expenses and this could cause our revenues to suffer.
- The product lifetime subscriptions we offered in the past obligate the company for an indefinite period and may not be large enough to cover future increases in costs.
- If there is increased use of switched technologies to transmit television programs by cable operators (also known as switched digital) in the future, the desirability and competitiveness of our current products could be reduced.
- We need to safeguard the security and privacy of our subscribers' confidential data, and any inability to do so may harm our reputation and brand and expose us to legal action.
- Product defects, system failures or interruptions to the TiVo service may have a negative impact on our revenues, damage our reputation and decrease our ability to attract new customers.
- We have limited experience in providing service and operations internationally that are subject to different laws, regulations, and requirements than those in the U.S. and our inability to comply with such could harm our reputation, brand, and have a negative impact on revenues.
- If we are unable to raise additional capital through the issuance of equity, debt, or other financing activities on acceptable terms, our ability to effectively manage growth and build a strong brand could be harmed.
- We expect continued volatility in our stock price.

The full list of TiVo's risks was daunting, but nothing terribly unusual for a fast-growing entrepreneurial venture. The big issue facing top management was how to make the company profitable without slowing its growth. Investors have a limited amount of patience. A no-dividend policy made sense for a fast-growing entrepreneurial company, but a low, volatile stock price was not going to be acceptable for long. How long can the company continue to sell TiVo DVRs when the competition was selling DVRs at a lower price or even offering them for free? What should Rogers do?

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CASE 15

Marvel Entertainment Inc.:

IRON MAN TO THE RESCUE

Ellie A. Fogarty and Joyce P. Vincelette

Introduction

POW! BAM! ZAP! IN 2008, MARVEL MAN'S ENTIRE UNIVERSE SHIFTED. After 70 years of ferocious struggle, Marvel Man's domination of the printed page was strong, with occasional swipes by his long-time nemesis DC Man and some puny domestic and foreign rivals. With no longer the need to fight on every frontier to protect his formidable assets from being exploited, Marvel Man was able to share his super strengths through lucrative licensing agreements with other trusted big-name heroes who understood the ins and outs of their own competitive worlds. Marvel Man was growing up and leaving toys behind. The new skirmishes would be fought online and on the big screen. What surprises await Marvel Man in these new media worlds? Which Hollywood villains might strike first—the writers or the actors? How can Marvel Man stay fresh and relevant in these changing times? What superhuman strength will be needed to triumph over sinister intellectual property thieves? What nefarious plot would the unpredictable Wall Street Woman concoct and would it involve battling a bear or a bull? Keep alert, loyal followers, and welcome to a brand new day!

History

Today's Marvel Entertainment Inc. traces its long, complicated history back to a small comic book company, Timely Comics, which was owned by Martin Goodman in the 1930s. A New York publisher of pulp magazines, Goodman's selections featured stories about detectives,

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science fiction, Westerns, crime, and horror. Following closely on the heels of rival DC Comics, which had just introduced Superman and Batman, Timely Comics produced its first Marvel Comics series in 1939, featuring the Human Torch and Namor the Sub-Mariner. The issue sold well and solidified Goodman's interest in the superhero genre. By late 1940, the first Captain America issue was an instant success as he battled the emerging Nazi threat. At $.10 an issue, comic books provided the action-packed distraction that the Depression-era generation needed. Stanley Leiber, better known as Stan Lee, began working as an assistant in 1940 at his cousin Goodman's company. Lee would later become synonymous with Marvel Comics as an editor, manager, and spokesman. Goodman's company grew rapidly throughout the 1930s and 40s during the Golden Age of comic books.

In the early 1950s, Goodman created Atlas News Company, which he set up as his national distribution system. Timely Comics was renamed Atlas Publishing in 1951. During the 1950s, the entire comic book industry slowed, not only from the popularity of television, but also from a newly created censorship board, the Comics Code Authority, whose special seal of approval guaranteed inoffensive, and bland, content between the pages. Distribution operations at Atlas News Company were suspended in 1956, forcing Atlas Publishing into a distribution deal with competitor DC Comics to get a limited number of comics in the Marvel series out per month.

In the 1960s, the re-emergence of superheroes appealed to the baby boomer generation, now in high school and on college campuses. It was in 1962 that Stan Lee co-created Marvel's most recognizable character, Spider-Man. Over the next few years, with the releases of the Fantastic Four, the Incredible Hulk, the Avengers, and the X-Men, the company, now publishing under the name Marvel Comic Groups, began merchandising its products and debuted its first superhero show on the ABC television network. Although the company was still reporting strong sales, its profits had dropped due to consolidating distribution outlets. The increasing popularity of chain supermarkets, which did not carry comic books, hurt many comic book publishers that had relied on corner grocers as a primary distribution outlet. In 1968, Goodman sold Atlas, including the Marvel Comics series, to Perfect Film and Chemical Corporation, which was then re-named Cadence Industries. Marvel Comics existed within Cadence as part of a business unit called Magazine Management. By the end of the 1970s, the market for comic books was reduced to an all-time low. Readers had lost interest in comics.

In the 1980s, the growing number of comic book collectors ushered in a wave of stores dedicated to the sales of comic books. Marvel began to target different demographics in the market, and began to use new distribution outlets including shopping malls. Marvel's revenues continued to grow through character license agreements. As part of a liquidation, Marvel was sold by Cadence to New World Entertainment for $46 million in 1986. Ron Perelman, through his Andrews Group and MacAndrews & Forbes holding companies, acquired Marvel from New World Entertainment in 1988 for $82.5 million and formed Marvel Entertainment Group.

In June of 1991, Perelman announced that Marvel would sell its stock to the public for the first time. Perelman pushed Marvel to expand into other areas with the 1992 purchase of Fleer Corporation, which made trading cards, and the 1993 exchange of a 46% interest in Toy Biz, a toy company owned by Isaac Perlmutter, in return for the use of Marvel's characters. Throughout the early nineties, Marvel completed a number of acquisitions, including children's kites (Sepctra Star), stickers (Panini), toy rockets (Quest), smaller publishers (Welsh Publishing and Malibu Comics), another trading card company (SkyBox), and a distribution operation (Superhero Enterprises). Marvel Mania was opened as a theme restaurant with servers in costume and menu selections with superhero descriptions. Confusion reigned as various firms claimed specific rights to produce and distribute films with Marvel characters. For example, Columbia Tristar Home Video claimed video cassette rights and Viacom claimed television rights for a possible motion picture based on Spider-Man. By December 1996, Marvel filed for bankruptcy amid plunging sales and mounting debt.

In 1997, Perelman was accused of helping to divert over $553 million from Marvel to his other companies before the bankruptcy. The suit was finally settled when Perelman agreed to pay former shareholders $80 million in 2008.[1] Perelman was ousted by the board, and Carl Icahn, a major bondholder, won control of the company for about a year until the courts appointed a Chapter 11 trustee at the end of 1997. After Icahn's failed attempts at a plan of reorganization, the company merged and became a wholly-owned subsidiary of Toy Biz in 1998. Toy Biz became known as Marvel Enterprises Inc. and changed the trading symbol for Toy Biz stock on the New York Stock Exchange to MVL. Additional legal issues were resolved with movie studios and Marvel entered into a joint venture with Sony Pictures to develop the Spider-Man movie franchise. Also during the late nineties, the company streamlined publishing efforts, diversified with licensing agreements that would help restore Marvel's image, and expanded into foreign markets hungry for Marvel superheroes. To signal its move into the entertainment industry, Marvel Enterprises changed its name to Marvel Entertainment Inc. in September 2005. After signing a master toy licensing agreement with Hasbro in 2006, Marvel began its exit from its toy manufacturing and distributing businesses. Marvel made some of its comic book archives available online through its Digital Comics division in 2007. By the end of the decade, Marvel was well on its way to becoming a leader in the entertainment industry, with two self-produced feature films in 2008 (Iron Man and the Incredible Hulk) and the funding and creative ideas for many more.

Marvel Entertainment Inc.'s history bears a striking resemblance to one of its downtrodden superheroes that battles rivals and fights injustices. As it transitioned from a traditional publisher and toy maker into a new media and entertainment company, would Marvel emerge triumphant over the forces of intense competition and flagrant disregard for the principles of intellectual property?

Corporate Governance

Board of Directors

Exhibit 1 lists the company's board of directors and the compensation received by each in 2007. The 8 directors were:[2]

Isaac Perlmutter, 65, had been Marvel's Chief Executive Officer since January 1, 2005, and was employed by Marvel as vice chairman of the board of directors since November 2001. Mr. Perlmutter was a director since April 1993 and served as chairman of the board of directors until March 1995. Perlmutter held over 37% of the company's common stock outstanding

EXHIBIT 1
Board of Directors: Marvel Entertainment Inc.

Name	Age	Title	Compensation
Handel, Morton E.	72	Chairman of the Board	$868,160
Perlmutter, Isaac	65	Vice Chairman of the Board, Chief Executive Officer	$3,872,797
Breyer, James W.	46	Director	$273,210
Charney, Laurence N.	60	Director	$192,180
Cuneo, F. Peter	63	Vice Chairman of the Board (Non-Executive)	$387,984
Ganis, Sid	68	Director	$435,710
Halpin, James F.	57	Director	$298,210
Solar, Richard L.	68	Director	$312,984

SOURCE: *Marvel Entertainment, Inc. Proxy Statement (May 5, 2008), pp. 4–5, 7.*

as of March 2008.[3] Under the terms of a share disposition agreement in February 2008, Perlmutter agreed not to sell any of his Marvel stock until the company's share repurchase program ended in March 2010.[4]

F. Peter Cuneo, 63, was Marvel's president and chief executive officer from July 1999 through December 2002 and served as the part-time special advisor to Marvel's chief executive officer from January 2003 through December 2004. Mr. Cuneo had been a Marvel director since July 1999, and since June 2003 he served as a non-executive vice chairman of the board of directors. Mr. Cuneo was a senior advisor to Plainfield Asset Management LLC, a hedge fund based in Greenwich, CT, that specialized in special and distressed situations. Mr. Cuneo was a director of Iconix Brands Inc.

Sid Ganis, 68, had been a Marvel director since October 1999. Mr. Ganis was the president of the Academy of Motion Picture Arts and Sciences, the organization that awards the Oscars. Mr. Ganis had been president of Out of the Blue . . . Entertainment, a company that he founded, since September 1996. Out of the Blue . . . Entertainment was a provider of motion pictures, television and musical entertainment for Sony Pictures Entertainment and others. From January 1991 until September 1996, Mr. Ganis held various executive positions with Sony Pictures Entertainment, including vice chairman of Columbia Pictures and president of Worldwide Marketing for Columbia/TriStar Motion Picture Companies.

James F. Halpin, 57, had been a Marvel director since March 1995. Mr. Halpin retired in March 2000 as president and chief executive officer and a director of CompUSA Inc., a retailer of computer hardware, software, accessories and related products, with which he had been employed since May 1993. Mr. Halpin was a director of Life Time Fitness Inc.

James W. Breyer, 46, had been a Marvel director since June 2006. Mr. Breyer had served as a partner of the Silicon Valley-based venture capital firm, Accel Partners, since 1995. Mr. Breyer was a director of Wal-Mart Stores Inc. and RealNetworks Inc. Mr. Breyer also served on the boards of various privately held companies. Mr. Breyer was a member of the board of dean's advisors to Harvard Business School and was chairman of the Stanford Engineering Venture Fund.

Laurence N. Charney, 60, had been a Marvel director since July 10, 2007. Mr. Charney retired from his position as a partner of Ernst & Young LLP in 2007, having served that firm for over thirty-five years. At Ernst & Young, Mr. Charney most recently served as the Americas director of conflict management. In that role he had oversight and responsibility in ensuring compliance with global and local conflict of interest policies for client and engagement acceptance across all service lines. Mr. Charney previously served as an audit partner and was Marvel's audit partner for its 1999 through 2003 audits.

Morton E. Handel, 72, had been the chairman of the board of directors of Marvel since October 1998 and was first appointed as a director in June 1997. Mr. Handel was a director of Trump Entertainment Resorts Inc. and served from 2000 until February 2006 as a director of Linens 'N Things Inc. Mr. Handel was also a regent of the University of Hartford and was active on the boards of several not-for-profit organizations in the Hartford, CT, area.

Richard L. Solar, 68, had been a Marvel director since December 2002. Since February 2003, Mr. Solar had been a management consultant and investor. From June 2002 to February 2003, Mr. Solar acted as a consultant for Gerber Childrenswear Inc., a marketer of popular-priced licensed apparel sold under the Gerber name, as well as under licenses from Baby Looney Tunes, Wilson, Converse and Coca-Cola. From 1996 to June 2002 (when Gerber Childrenswear was acquired by the Kellwood Company), Mr. Solar was senior vice president, director and chief financial officer of Gerber Childrenswear. Mr. Solar was also vice president and treasurer of Barrington Stage Company Inc., which produced plays, developed experimental musicals and provided a program for at-risk high school students in the Berkshires.

EXHIBIT 2
Corporate Officers: Marvel Entertainment, Inc.

Name	Age	Title	Compensation
Perlmutter, Isaac	65	Vice Chairman of the Board, Chief Executive Officer	$3,872,797
West, Kenneth P.	49	Executive Vice President, Chief Financial Officer	$766,526
Fine, Alan	57	Executive Vice President, Publishing/Toy/Characters	$632,420
Maisel, David	45	Executive Vice President, Marvel Studios	$4,118,999
Turitzin, John	52	Executive Vice President, Legal/General Counsel	$1,390,212

SOURCE: *Marvel Entertainment, Inc. Proxy Statement (May 5, 2008), pp. 13, 23.*

Corporate Officers

Exhibit 2 lists Marvel's corporate officers and the compensation received by each in 2007. In addition to Mr. Isaac Perlmutter, listed earlier, there were four other key corporate officers:[5]

Alan Fine (57) had served as executive vice president and chief marketing officer of Marvel Characters Inc. (a wholly owned subsidiary of Marvel Entertainment Inc. that owned and licensed Marvel's intellectual property library) since May 2007. Mr. Fine also had served as Chief Executive Officer of Marvel's publishing division since September 2004, and as Chief Executive Officer of Marvel's toy division since August 2001 and from October 1998 to April 2001.

David Maisel (45) had served as executive vice president, Office of the Chief Executive, since September 2006 and became chairman of Marvel Studios in March 2007. From September 2005 until September 2006, Mr. Maisel served as executive vice president, Corporate Development, and from September 2005 until March 2007, Mr. Maisel served as vice chairman of Marvel Studios. From January 2004 to September 2005, Mr. Maisel served as president and chief operating officer of Marvel Studios. From October 2001 to November 2003, Mr. Maisel headed Corporate Strategy and Business Development for Endeavor Agency, a Hollywood literary and talent agency.

John Turitzin (52) had served as executive vice president, Office of the Chief Executive, since September 2006. From February 2006 until September 2006, Mr. Turitzin served as Marvel's chief administrative officer. Mr. Turitzin had also served as an executive vice president and general counsel since February 2004. From June 2000 to February 2004, Mr. Turitzin was a partner in the law firm of Paul, Hastings, Janofsky & Walker LLP.

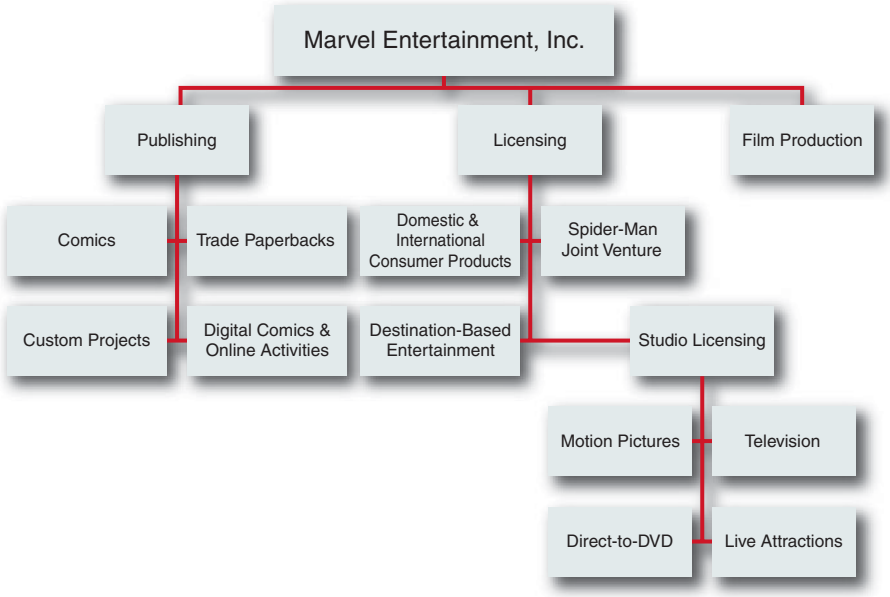
Kenneth P. West (49) had served as executive vice president and chief financial officer since June 2002.

Corporate Structure

Primary Operating Segments

In the first quarter of 2008, Marvel Entertainment eliminated its Toy division and reorganized into three operating segments: Publishing, Licensing, and Film Production. Marvel operated in these markets both domestically and internationally, although the U.S. market made up an average of over 70% of the company's annual revenues. Because each segment depended on Marvel's extensive library of characters, the company emphasized the integrated and complementary nature of the three segments. **Exhibit 3** shows Marvel's primary business segments and **Exhibit 4** lists Marvel's subsidiaries.

EXHIBIT 3
Business Segments: Marvel Entertainment, Inc.



SOURCE: *Derived from Marvel Entertainment, Inc.,* Form 10-Q *(June 30, 2008), pp. 11–12 and Cuneo & Turitzin presentation at JP Morgan US Mid Cap Growth Conference, London, (Sept. 30, 2008), pp. 6–7, 13.*

For most of its history, Marvel's primary direct competitors had been other comic book publishers, such as the well-established DC Comics, a subsidiary of Warner Bros., and the publisher of Superman, Batman, and Wonder Woman comics, and the much younger Dark Horse Comics. As Marvel repositioned itself as an entertainment firm, the company faced competition from industry giants such as the Walt Disney Company and NBC Universal.

The **Publishing** segment created and published comic books, trade paperbacks, custom comics, and digital comics. Well-known characters included Spider-Man, X-Men, Fantastic Four, Iron Man, the Incredible Hulk, Captain America, and Ghost Rider. The segment also received revenues from related advertising and subscription operations. Publishing contributed between 25% to 30% of the company's annual net sales, with revenues coming overwhelmingly (85%) from the U.S. market. Segment revenues were $125,657,000, $108,464,000, and $92,455,000 in 2007, 2006, and 2005, respectively.

Over the course of 70 years, Marvel developed an extensive library of over 5,000 characters, most of which were developed and popularized through published comic books (see **Exhibit 5** for a listing of popular characters). The publishing segment had published comic books since 1939 and was able to present characters in contemporary dramatic settings that were suggestive of real people with real problems. The ability to stay relevant enabled Marvel to retain the attention of old readers, while also attracting the attention of new readers over time.

In 2008, Marvel was focused on expanding its distribution channels as well as its product lines. Comic books were distributed through three main channels: comic book specialty stores, traditional retail outlets such as bookstores and newsstands, and on a subscription basis. Approximately 70% of the Publishing segment's revenues were attributed to sales from comic book specialty stores, also known as the "direct market." Another 15% of the Publishing net sales were derived from sales to the mass market retail outlets. The final 15% of the segment's revenues came from sales of advertising and subscriptions, including its online business. Because of the growth of the Internet and the potential for online readership, online comic books were launched in 2007 through Marvel Digital Comics Unlimited, in an attempt to reach existing readers in a new medium while also further extending Marvel's reach to new readers.

EXHIBIT 4
Subsidiaries: Marvel Entertainment, Inc.

	Name	Jurisdiction of Organization
1	Marvel Characters, Inc.	Delaware
2	Marvel Characters B.V.	The Netherlands
3	MVL International C.V.	The Netherlands
4	Marvel International Character Holdings LLC	Delaware
5	Marvel Entertainment International Limited	United Kingdom
6	Marvel Property Inc.	Delaware
7	Marvel Publishing Inc.	Delaware
8	Marvel Internet Productions LLC	Delaware
9	Marvel Toys Limited	Hong Kong
10	Spider-Man Merchandising L.P.**	Delaware
11	MRV, Inc.	Delaware
12	Marvel Studios, Inc.	Delaware
13	MVL Film Finance LLC*	Delaware
14	MVL Productions LLC*	Delaware
15	MVL Rights LLC*	Delaware
16	MVL Development LLC	Delaware
17	Marvel Film Productions LLC	Delaware
18	Iron Works Productions LLC*	Delaware
19	Incredible Productions LLC*	Delaware
20	MVL Iron Works Productions Canada Inc.*	Province of Ontario
21	MVL Incredible Productions Canada, Inc.*	Province of Ontario
22	Asgard Productions LLC	Delaware
23	Marvel Animation, Inc.	Delaware
24	Green Guy Toons LLC	Delaware
25	Squad Productions LLC	Delaware

*Wholly owned subsidiaries formed as Film Slate Subsidiaries
**Joint venture with Sony Pictures for licensing Spider-Man

SOURCE: *Marvel Entertainment, Inc., Form 10-K (Dec. 31, 2007), Exhibit 21.*

EXHIBIT 5
Popular Characters: Marvel Entertainment Inc.

Ant-Man
Avengers
Black Panther
Blade
Captain America
Cyclops
Daredevil
Dr. Doom
Dr. Strange
Elektra
Emma Frost
Fantastic Four
Gambit
Ghost Rider
Hawkeye
Human Torch
Incredible Hulk
Iron Man
Mr. Fantastic
Multiple Man
Nick Fury
Nightcrawler
Phoenix
Silver Surfer
Spider-Girl
Spider-Man
Sub-Mariner
The Punisher
The Thing
Thor
Wolverine
X-Men

In the publishing industry, Marvel was the number one publisher of comic books in the United States with over 40% of the market. DC Comics followed with approximately 30% in 2007. Dark Horse Comics comprised about 5% of the comic book market.[6] Throughout their histories, Marvel and other comic book publishers struggled to expand readership beyond teenage boys. Various attempts included romance comics, female superheroes, and adult-themed comics. The most recent and successful expansion in this industry was the introduction of Japanese comics called "manga" which often included stories with girl-friendly content and were distributed to both comic book shops and mainstream bookstores.[7] Some comic book publishers also entered the field of graphic novels, which was well-suited to serialized stories. In 2008, Marvel had eight product lines that targeted different age groups and interests. These included stories taken from classic literature (the Iliad), stories from best-selling authors, and an all-ages print line for Wal-Mart and Target. Rival comic book company DC Comics had five print lines including a manga-type line and one primarily for teenage girls. DC also used established novelists to draw new readers to its publications.[8]

The **Licensing** segment typically delivered over half of the company's net sales in a year. An average of 70% of these sales were generated in the U.S. market. Licensing revenues were $272,722,000, $127,261,000, and $230,063,000 in 2007, 2006, and 2005 respectively. The Licensing segment directed the licensing, promotion, and brand management for all Marvel characters worldwide. Marvel pursued a strategy of concentrating licensee relationships with fewer, larger licensees who demonstrated superior financial and merchandising capability.[9]

Revenues within this segment were broken into four categories as of 2007. This was before the restatement of Toys revenues within the segment. The Domestic Consumer Products category represented $71.8 million or about 25% of total licensing sales in 2007. International Consumer Products made up another $41.8 million. The Spider-Man Joint Venture with Sony accounted for $122 million, or 45%, of total sales in this segment. Marvel Studios licensing made up $37.1 million in 2007.[10] Marvel was ranked within the top five licensing companies by sales by *License!* magazine in 2008 (See **Exhibit 6**).

EXHIBIT 6
Top Licensing Companies, 2008

		(Dollar Amounts in Billions)		
Rank	**Company**	**Sales 2007**	**Sales 2006**	**Brands**
1	Disney Consumer Brands	$26.0	$24.0	Hannah Montana, High School Musical, Disney Princesses, Disney Fairies, Pixar's Cars, Chronicles of Narnia
2	Phillips-Van Heusen	$6.7	$6.7	Van Heusen, Arrow, Izod, Bass
3	Warner Bros. Consumer Products	$6.0	$6.0	Harry Potter and the Order of the Phonenix, The Dark Knight, Speed Racer, Where the Wild Things Are
4	Iconix	$6.0	NA	Candie's, Starter, Joe Boxer, OP, Cannon, Royal Velvet, Mudd, Mossimo
5	Marvel Entertainment Inc.	$5.5	$4.8	Spider-Man, X-Men, Hulk, Iron Man, Fantastic Four, Avengers, Spider-Man & Friends
6	Nickelodeon & Viacom Cons. Prod.	$5.5	$5.3	Dora, Diego, The Backyardigans, Ni-Hao, Kai Lan, SpongeBob SquarePants, South Park, Neopets
7	Major League Baseball	$5.1	$4.7	Major League Baseball
8	Sanrio	$5.0	$5.2	Hello Kitty, Keroppi, Kuromi, Badtz-Maru
9	Cherokee Group	$4.0	NA	Cherokee, Sideout, Carole Little
10	National Football League	$3.4	$3.2	National Football League

SOURCE: License! Global's *Top 100 Licensing Companies (April 2008).*

Marvel shifted its toy business to Hasbro during the first quarter of 2008. According to the company:

> *We also completed a change in the focus of the support that we provide to Hasbro, which resulted in changes to our internal organizational structure and staff reductions. These events altered our internal reporting of segment performance, with the result that we are now including revenues earned from Hasbro (associated with toys manufactured and sold by Hasbro) and related expenses (associated with royalties that we owe on our Hasbro revenue) within our Licensing segment. Those revenues and expenses were formerly included in our Toy segment.*[11]

Seeking a strategic partnership with a recognized industry giant, Marvel entered a 5-year master toy license with Hasbro for the period January 1, 2007, to December 31, 2011. The agreement gave Hasbro the exclusive right to make action figures, plush toys, and certain role-play toys, and non-exclusive rights for several other types of toys, using Marvel's characters. The Hasbro agreement was reached after the early termination of a prior 5 1/2-year agreement with Toy Biz Worldwide Limited (TBW) in December 2005, for which Marvel took a $12.5 million non-recurring expense. The agreement with TBW, a Hong Kong toy maker totally unrelated to the Toy Biz company previously owned by Perlmutter, began in 2001 and gave TBW the right to use Marvel characters, except for Spider-Man, in producing and selling action figures and accessories. During the interim year (2006), Marvel produced and sold its own toys, with TBW serving as a sourcing agent to help Marvel locate factories in China.

Marvel faced intense competition in the toy industry and relied on the expertise of Hasbro to reach two main target markets: boys, primarily ages four through 13, and collectors aged 18–44. For 2007, the last time that the company would report revenues in the Toy segment, U.S. toy sales were responsible for about 60% of Marvel's Toy segment sales. Beginning in 2008, domestic and international licensing revenues from toy sales were reflected in the licensing segment.

With such an extensive catalog of characters, Marvel partnered with numerous companies such as Activision and Sega for video games, Leapfrog for electronics, Hallmark for party supplies, General Mills and 7-11 for food and beverages, and Johnson & Johnson for health & beauty products. Footwear deals included an exclusive collection of children's sneakers for Reebok featuring Iron Man and the Incredible Hulk and sold only at Foot Locker and Kids Foot Locker, as well as another deal with Crocs Inc. Fruit of the Loom held the licensing agreement for children's underwear printed with Marvel characters. As part of the licensing agreements, Marvel received a flat fee for access to any proprietary character in addition to per unit fees for every Marvel licensed item sold.

In 2007, Marvel began to enhance the product development and merchandising of its consumer product categories. In addition to its mass market mainstays, Wal-Mart and Target, Marvel was moving into new distribution channels such as Pottery Barn Kids with Spider-Man room furnishings and accessories designed exclusively for the retailer and its more upscale consumers. Additional deals were in place with Nordstrom, Fred Segal, and H&M.[12]

Although Marvel created its own film production business unit, there were a number of outstanding licensing agreements with 20th Century Fox to produce major motion pictures featuring X-Men and the Fantastic Four. Under this agreement Marvel retained more than 50% of merchandising-based royalty revenue. Marvel also partnered with Lionsgate Entertainment Corp. for animated DVDs for the home video market and with FX, a cable network from FOX, to distribute Marvel's self-produced movies on cable.[13]

Marvel licensed its characters for use at Universal Studios theme parks in Orlando, Florida, and Osaka, Japan. In 2008, characters had been licensed for the development of a major theme park in Dubai, two theme parks in South Korea, and a Broadway musical of Spider-Man with director Julie Taymor (*The Lion King*) and music by U2's Bono and The Edge. Characters were licensed by other companies for short-term promotions of products and services, and were used in foreign-language comic books, paperbacks, and coloring books.

Spider-Man Merchandising L.P. was a joint venture between Marvel and Sony Pictures Entertainment Inc. for the purpose of pursuing licensing opportunities relating to characters based upon movies or television shows featuring Spider-Man and produced by Sony. Marvel maintained control of decision making and received the majority of the financial interest of the joint venture.[14]

The **Film Production** segment included self-produced feature films. Marvel planned to self-produce all future films based on characters that had not already been licensed to third parties. The company felt it would have more control of films and have greater flexibility with respect to the coordination of licensed products and film release timing. Marvel financed new films through a $525 million credit facility funded by Merrill Lynch that enabled Marvel to independently finance the development and production of up to 10 feature films over eight years. The theatrical film rights of 12 second-tier characters and their supporting partners or rivals were pledged as collateral to the film facility, including Ant-Man, Black Panther, Captain America, Doctor Strange, Nick Fury, and The Avengers. **Exhibit 7** shows the schedule of films and studios involved.

Marvel formed seven wholly owned subsidiaries, known as the Film Slate Subsidiaries, in connection with the film facility, that are identified in **Exhibit 4**. The first two films produced by this $525 million investment were *Iron Man* and *The Incredible Hulk*, both of which were released in mid-2008 with successful opening weekends of $98.6 million and $55.4 million, respectively.[15] Paramount Pictures distributed *Iron Man*, staring Robert Downey Jr., Gwyneth Paltrow, Terrence Howard, and Jeff Bridges, and Universal Pictures distributed *The Incredible Hulk*, staring Edward Norton, Liv Tyler, William Hurt, and Tim Roth. Marvel began reporting revenues for the Film Production segment in the second quarter of 2008. In September 2008, Marvel leased sound stages, equipment, production spaces, and corporate offices in California through its MVL Productions LLC subsidiary to make its next four self-produced films.[16]

EXHIBIT 7
Film Schedule and Studio: Marvel Entertainment Inc.

2000	*X-Men*	Fox
2002	*Spider-Man*	Sony
2003	*Daredevil*	Fox
	X2: X-Men United	Fox
	Hulk	Universal
2004	*Spider-Man 2*	Sony
2005	*Elecktra*	Fox
	Fantastic Four	Fox
2006	*X-Men: The Last Stand*	Fox
2007	*Ghost Rider*	Sony
	Spider-Man 3	Sony
	Fantastic Four-ROTSS	Fox
2008	*Iron Man*	Marvel
	Incredible Hulk	Marvel
	Punisher: War Zone	Lionsgate
2009	*X-Men Origins: Wolverine*	Fox
2010	*Iron Man 2*	Marvel
	Thor	Marvel
2011	*The First Avenger: Captain America*	Marvel
	The Avengers	Marvel

SOURCE: *Cuneo & Turitzin presentation at JP Morgan US Mid Cap Growth Conference, London, (Sept. 30, 2008), pp. 14–15 and Marvel Entertainment, Inc. Form 8-K, May 9, 2008, p. 3.*

The move to self-produced films came as a result of hard learning experiences. Previous failed attempts in Hollywood and unfavorable movie deals left Marvel with nothing to show for its long history of investment in character and story development. In past arrangements, the company did not bear the production risks and in exchange it reaped a small percentage of the profits.[17] Sometimes Marvel would receive only 2 to 10 percent of profits of a feature film. For example, licensing mishandled during Ron Perelman's era brought Marvel only one million dollars from 1997's *Men in Black*, a film that generated close to $600 million worldwide. Another lesson was learned when Marvel made $25,000 from 1998's *Blade*, which brought in $133 million worldwide.[18] However, popular films produced by other companies using Marvel characters continued to generate increased licensing revenues for Marvel from toys and consumer products, and often reignited interest in the comic books themselves.

Cross-Segment Operations

Operating across segments was the company's Global Digital Media Group, established in 2008 to coordinate Marvel's expanding digital distribution strategy. This included Marvel Digital Comics Unlimited, part of the Publishing segment, as well as digital video, animated content, mobile games, and strategic partnerships.[19] In late 2007, Marvel launched its Digital Comics online subscription service, providing high-resolution Internet access and search capabilities to thousands of classic comic book titles from its archives as well as contemporary issues. Special features on the Web site included the first 100 issues of the *Amazing Spider-Man*, first-time appearances of specific super heroes, and series designed for young readers. Rival publisher DC Comics pushed technology beyond static, digitized versions of print materials by offering a hybrid of comic books and animation called "motion comics." DC's first motion comic series featured the Dark Knight and coincided with the release of the 2008 Batman movie. The series could be downloaded for game consoles, mobile phones, and video on demand.[20] Following DC's lead, Marvel partnered with thriller/horror author Stephen King to develop a 25-episode animated video of King's short-story "N," from his collection "Just After Sunset." Marvel created the episodes specifically for small screens and offered them via online and mobile channels prior to the book's release.[21]

Serious legal considerations influenced all of Marvel's operations, domestically and internationally. Marvel worked diligently to protect the most valuable assets of the company, its globally-recognized characters and stories. In addition to the company's registered trademarks and copyrights within the United States, Marvel attempted to protect its intellectual property abroad by registering trademarks in Africa, Asia, Latin America, the Middle East, and Western Europe.[22] According to the International Intellectual Property Alliance, over $18 billion in revenue was lost in 2007 by U.S. firms due to copyright piracy of software, music, and books.[23] Another $5 billion was lost by major U.S. motion picture studios.[24] Marvel's legal challenges also extend to the virtual world, including its fights to protect its intellectual property by challenging the superhero avatars designed by players of massively multiplayer online role-playing games (MMORPG). In a recent case against NCsoft, Marvel accused the videogame developers of infringement of copyright and trademarks. The case was dismissed and Marvel later settled with the NCsoft, leaving many important questions about copyright and the boundaries of fair use in game playing to be settled in the future.[25]

Marvel relied on hundreds of gifted individuals to conceive of, design, and deliver the wide-ranging and ever-changing adventures of Marvel characters. Legal issues related to talent included claims of copyright ownership made by freelance writers, disputes with former employees, and labor agreements with writers and actors. For example, Marvel faced a challenge during the 100-day strike in 2007–2008 of the Writers Guild of America (WGA), which represents writers in the motion picture, broadcast, cable, and new media industries. Progress on its ambitious film development slate stopped until Marvel negotiated an interim agreement

with the WGA to put the writers back to work. Marvel revised its two-films-per-year model and amended its agreement concerning the $525 million film slate credit facility.[26] As of November 2008, the Screen Actor's Guild (SAG) had been without a contract for five months and was seeking a strike authorization from its members.[27]

Financial Performance

Licensing segment net sales accounted for 56% of total net sales in 2007. The Publishing segment accounted for 26%, and Toys made up the remaining 18%. In 2007, revenue from foreign operations accounted for 30% of Marvel's total revenues, up from just 21% in 2005. **Exhibit 8** provides revenues by segment and geographic area for Marvel in 2007. As noted earlier, the company substantially exited the Toy business in early 2008 and began reporting revenues for the Film Production segment in the second quarter of 2008. As of the third quarter of 2008, Marvel's Licensing business accounted for $237,479,000 in net sales, down from a restated 2007 amount of $267,512,000. Publishing produced $92,322,000 in net sales, also down from a restated 2007 amount of $95,356,000. Film production made up $119,105,000 of net sales in the third quarter of 2008.[28]

As of late 2008, the global economy had entered a recessionary period. On the strength of its summer 2008 film releases, Marvel's share price appeared to be weathering the storm in late 2008. Because its characters were used across business segments, Marvel was able to leverage exposure from films to create revenues from sales of licensed merchandise. However, this ripple effect was expected to slow in the absence of new films or television shows. No self-produced films were scheduled for release in 2009.

Since emerging from bankruptcy in 1998, Marvel's net sales increased 110%, averaging nearly 14% growth per year. However, a closer analysis of Marvel's financials revealed wide fluctuations over the period. For fiscal year 2007, consolidated net sales were up 38% over 2006 to $485.8 million. The increase came after a 24% drop from 2004, when net sales exceeded $513.4 million, to 2005, and a further drop of 10% from 2005 to 2006. Marvel's consolidated statement of income is provided in **Exhibit 9** and **Exhibit 10**, consolidated balance sheet.

EXHIBIT 8

Revenues by Segment and Geographic Area: Marvel Entertainment Inc.

	(Dollar Amounts in Thousands)					
	2007		2006		2005	
	U.S.	Foreign	U.S.	Foreign	U.S.	Foreign
Licensing	$ 178,534	$ 94,188	$ 83,955	$ 43,306	$ 181,959	$ 48,104
Publishing	106,858	18,799	90,924	17,540	77,312	15,143
Toys[1]	53,100	34,328	82,171	33,902	47,695	20,294
Total	$ 338,492	$ 147,315	$ 257,050	$ 94,748	$ 306,966	$ 83,541

Note 1. $38.5 million and $4.4 million of U.S. toy revenue and $32.4 million and $0.8 million of foreign toy revenue for 2007 and 2006, respectively, is attributable to royalties and service fees generated by Hasbro. $37.1 million of the U.S. toy revenue and $14.7 million of the foreign toy revenues for 2005 are attributable to royalties and service fees from toy sales generated by TBW.

SOURCE: *Marvel Entertainment, Inc.,* Form 10-K *(Dec. 31, 2007), p. F-40.*

EXHIBIT 9

Consolidated Statements of Income: Marvel Entertainment, Inc. (Dollar amounts in thousands of dollars)

Year Ending December 31	2007	2006	2005
Net Sales	485,807	351,798	390,507
Costs and expenses:	—	—	—
Cost of revenues (excluding depreciation expense)	60,933	103,584	50,517
Selling, general and administrative	147,118	123,130	166,456
Depreciation and amortization	5,970	14,322	4,534
Total costs and expenses	$214,021	$241,036	$221,507
Other income, net	2,643	1,798	2,167
Operating income	$274,429	$112,560	$171,167
Interest expense	13,756	15,225	3,982
Interest income	2,559	1,465	3,863
Income before income tax expense and minority interest	$263,232	$98,800	$171,048
Income tax expense	(98,908)	(39,071)	(62,820)
Minority interest in consolidated joint venture	(24,501)	(1,025)	(5,409)
Net Income	$139,823	$58,704	$102,819
Basic and diluted net income per share:	—	—	—
Weighted average shares outstanding:	—	—	—
Weighted average shares for basic earnings per share	79,751	82,161	99,594
Effect of dilutive stock options, warrants and restricted stock	2,716	5,069	6,464
Weighted average shares for diluted earnings per share	82,467	87,230	106,058
Net income per share:	—	—	—
Basic	1.75	0.71	1.03
Diluted	1.70	0.67	0.97

SOURCE: *Marvel Entertainment, Inc., Form 10-K (Dec. 31, 2007), p. F-5.*

EXHIBIT 10

Consolidated Balance Sheet: Marvel Entertainment, Inc. (Dollar amounts in thousands)

Year Ending December 31	2007	2006
Assets	—	—
Current assets:	—	—
Cash and cash equivalents	30,153	31,945
Restricted cash	20,836	8,527
Short-term investments	21,016	—
Accounts receivable, net	28,679	59,392
Inventories, net	10,647	10,224
Income tax receivable	10,882	45,569
Deferred income taxes, net	21,256	22,564
Advances to joint venture partner	—	8,535
Prepaid expenses and other current assets	4,245	7,231
Total current assets	**$147,714**	**$193,987**
Fixed assets, net	**2,612**	**4,444**
Product and package design costs, net	—	1,497
Film inventory	264,817	15,055
Goodwill	346,152	341,708
Accounts receivable, non–current portion	1,300	12,879
Income tax receivable, non–current portion	4,998	—
Deferred income taxes, net	37,116	36,406
Deferred financing costs	11,400	15,771
Other assets	1,249	2,118
Total assets	$817,358	$623,865

(Continued)

EXHIBIT 10
(Continued)

Year Ending December 31	2007	2006
Current liabilities:	—	—
Accounts payable	3,054	5,112
Accrued royalties	84,694	68,467
Accrued expenses and other current liabilities	37,012	38,895
Deferred revenue	88,617	140,072
Film facilities	42,264	—
Minority interest to be distributed	556	—
Total current liabilities	$256,197	$252,546
Accrued royalties, non-current portion	10,273	12,860
Deferred revenue, non-current portion	58,166	35,667
Line of credit	—	17,000
Film facilities, non-current portion	246,862	33,200
Income tax payable, non-current portion	54,066	10,999
Other liabilities	10,291	6,702
Total liabilities	$635,855	$368,974
Commitments and contingencies	—	—
Stockholders—equity:	—	—
Preferred stock, $.01 par value, 100,000,000 shares authorized, none issued	—	—
Common stock, $.01 par value, 250,000,000 shares authorized, 133,179,310 issued and 77,624,842 outstanding in 2007 and 128,420,848 issued and 81,326,627 outstanding in 2006	1,333	1,284
Additional paid-in capital	728,815	710,460
Retained earnings	349,590	228,466
Accumulated other comprehensive loss	(3,395)	(2,433)
Total stockholders—equity before treasury stock	$1,076,343	$937,777
Treasury stock, at cost, 55,554,468 shares in 2007 and 47,094,221 shares in 2006	(894,840)	(682,886)
Total stockholders equity	181,503	254,891
Total liabilities and stockholders equity	$817,358	$623,865

SOURCE: *Marvel Entertainment, Inc.,* Form 10-K *(Dec. 31, 2007), p. F-4.*

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CASE 16

Carnival Corporation & plc (2010)

Michael J. Keeffe, John K. Ross III, Sherry K. Ross, Bill J. Middlebrook, and Thomas L. Wheelen

IT WAS EARLY MORNING IN NOVEMBER 2010 AS MICKEY ARISON, Chairman and CEO, drove up the palm-lined entryway to the headquarters of Carnival Corporation. In front of the building, the large Carnival red, white, and blue logo (shaped like a ship's funnel) reminded him that his ships were not only still afloat, but doing well in this down economy.

As he reflected back on the year, he was delighted that the company had weathered the global recession. Despite reduced leisure travel demand, the U.S. government's advisory against travel to Mexico as a result of the flu virus, terrorist fears, fuel price uncertainty, and a host of other factors, Carnival managed to carry a record 8.5 million guests. Although 2009 sales were below the 2008 record, the company still posted a $1.8 billion net income. Quick responses by management offset the revenue declines through cost containment efforts, most notably a 5% reduction in fuel consumption, and through expansion in its European market. This expansion represented 39% of the company's operations.

Third-quarter results (through August 31, 2010) showed improvement over the same period in 2009, nearing the record levels of 2008. In the Western Hemisphere, the gulf oil spill had not materially affected cruise operations and the hurricane season had not been as bad as predicted. European expansion proceeded smoothly and expansion initiatives in Australia and Asia produced positive results. Given a global economic recovery, the company should see a return to the historical growth patterns it experienced in previous years.

The strategic outlook through 2012 and beyond was projected to be highly favorable. Carnival Corporation's management believed that only 20% of the U.S. population, 9%–10% of the UK population, and 4%–5% of the continental European population had ever taken a cruise. This left a large number of potential cruise guests. European growth potential was consistent with the North American market 12 years ago. Anticipating this growth, Carnival Corporation intended to continue average annual capacity growth in North America at a 3% rate and European capacity growth at 9% through 2012.

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Overview

In 1972, Ted Arison founded Carnival Cruise Lines with one ship, the *Mardi Gras*. Ted Arison's son, Mickey Arison, now served as Chairman and CEO. **Exhibit 1** shows the brands, passenger capacity, number of ships, and primary market from the 2010 Annual Report. By late 2010, the number of operating ships had increased to 98 ships serving seven continents.

Ships added during 2010 included the *Costa Deliziosa*, *Nieuw Amsterdam*, *Azura*, *AIDAblu*, *Queen Elizabeth*, and the *Seabourn Sojourn*. Carnival's 98 ships had a capacity of over 190,000 passenger berths. Given that fleet-wide occupancy rates usually hover at or above 100% (ship berths are at double occupancy and additional berths can be made available), and with over 70,000 shipboard employees, more than 260,000 people were sailing aboard the Carnival fleet at any given time (**Exhibit 2**). Additionally, Carnival Corporation

EXHIBIT 1
Cruise Brands, Passenger Capacity, Number of Cruise Ships, and Primary Markets

Cruise Brands	Passenger Capacity (a)	Number of Cruise Ships	Primary Markets
North America			
Carnival Cruise Lines	54,480	22	North America
Princess	37,608	17	North America
Holland America Line	23,492	15	North America
Seabourn	1,524	5	North America
North America Cruise Brands	117,104	59	
Europe, Australia, & Asia ("EAA")			
Costa	29,202	14	Italy, France, and Germany
P&O Cruises (UK) (b)	15,098	7	United Kingdom ("UK")
AIDA	12,054	7	Germany
Cunard	6,676	3	UK and North America
P&O Cruises (Australia)	6,322	4	Australia
Ibero	5,008	4	Spain and South America
EAA Cruise Brands	74,360	39	
	191,464	98	

(a) In accordance with cruise industry practice, passenger capacity is calculated based on two passengers per cabin even though some cabins can accommodate three or more passengers.
(b) Includes the 1,200-passenger capacity *Artemis,* which was sold in October 2009 to an unrelated entity and is being operated by P&O Cruises (UK) under a bareboat charter agreement until April 2011.

SOURCE: *Carnival Corporation & plc 2010 Annual Report.*

EXHIBIT 2
Passengers, Capacity, and Occupancy

Fiscal Year	Cruise Passengers	Year-End Passenger Capacity	Occupancy
2005	6,848,000	136,960	105.6%
2006	7,008,000	143,676	106.0%
2007	7,672,000	158,352	105.6%
2008	8,183,000	169,040	105.7%
2009	8,519,000	180,746	105.5%
2010	9,147,000	191,464	105.6%

SOURCE: *Carnival Corporation & plc 2010 Annual Report.*

expected delivery of nine ships by the end of 2014 (Carnival–2; Costa–2; AIDA–2; Seabourn–1; Princess–2).

In a letter to stockholders, Arison stated that, ". . . While our targeted brands and strategic growth initiatives remain important ingredients for success, and entrepreneurial spirit is what our company thrives on. . . . Our culture empowers our brand managers to make daily decisions to the best interest of building their respective operating companies. Each brand is accountable for its individual performance."

Carnival not only owned ships but also owned a chain of 16 hotels and lodges in Alaska and the Canadian Yukon with 3,000 guest rooms to complement Alaska cruises. For "Alaskan cruise tours," Carnival operated two luxury day trips to the glaciers in Alaska and the Yukon River and owned 30 domed rail cars operated by the Alaska Railroad as sight-seeing trains.

The Evolution of Cruising

When aircraft replaced ocean liners as the primary means of transoceanic travel during the 1960s, the opportunity for developing the modern cruise industry was created. Ships that were no longer required to ferry passengers from destination to destination became available to investors who envisioned new alternative vacations that complemented the increasing affluence of Americans. Ted and Mickey Arison envisioned travelers experiencing classical cruise elegance, along with the latest modern conveniences, at a price comparable to land-based vacation packages sold by travel agents. Carnival's all-inclusive package, when compared to packages at resorts or theme parks such as Walt Disney World, often were priced below those destinations, especially when the array of activities, entertainment, and meals were considered. Once the purview of the rich and leisure class, cruising was now targeted to the middle class, with service and amenities similar to the grand days of first-class ocean travel.

According to Cruise Travel magazine, the increasing popularity of taking a cruise as a vacation can be traced to two serendipitously timed events. First, television's *Love Boat* series dispelled many myths associated with cruising and depicted people of all ages and backgrounds enjoying the cruise experience. During the 1970s, this show was among the top 10 television programs and provided extensive publicity for cruise operators. Second, the increasing affluence of Americans and the increased participation of women in the workforce gave couples and families more disposable income for discretionary purposes, especially vacations. As the myths were dispelled and disposable income grew, younger couples and families realized the benefits of cruising as a vacation alternative, creating a large new target market for the cruise product and accelerating growth in the number of Americans taking cruises as a vacation.

Over the last 20 years the cruise industry and cruise vacation have matured with the development of ships designed specifically for cruise vacations and varied itineraries worldwide. Current cruise liners bear little resemblance to early industry cruise liners and are truly a floating vacation resort. Modern cruise ships are much larger than previous ships, have little motion due to computer-controlled stabilization systems, are environmentally friendly with full recycling capabilities, and have a multitude of activities, entertainment, clubs, and deck spaces for guests to explore. The common misconception of being perpetually seasick or bored on a ship would be hard to fathom given the evolution and development of modern cruise ships and the many and varied ports of call.

Carnival History

In 1972 Ted Arison, backed by the American Travel Services Inc. (AITS) purchased an aging ocean liner from Canadian Pacific Empress Lines for $6.5 million. The new AITS subsidiary, Carnival Cruise Lines, refurbished the vessel from bow to stern and renamed it the *Mardi Gras* to capture the party spirit. (Also included in the deal was another ship later renamed the *Carnivale*.) The company's beginning was less than promising when the *Mardi Gras* ran aground in Miami Harbor with more than 300 invited travel agents aboard. The ship was slow and guzzled expensive fuel, which limited the number of ports of call and lengthened the minimum stay of passengers on the ship needed to reach break-even. Arison then bought another older vessel from the Union Castle Lines to complement the *Mardi Gras* and the *Carnivale* and named it the *Festivale*. To attract customers, Arison began adding onboard diversions such as planned activities, a casino, discos, and other forms of entertainment designed to enhance the shipboard experience.

Carnival lost money for the next three years, and in late 1974 Ted Arison bought out the Carnival Cruise subsidiary from AITS Inc. for $1 cash and the assumption of $5 million in debt. One month later, the *Mardi Gras* began showing a profit and, through the remainder of 1975, operated at more than 100% capacity. (Normal ship capacity was determined by the number of fixed berths [referred to as lower berths available]. Ships, like hotels, operate beyond this fixed capacity by using rollaway beds, pullmans, and upper bunks.)

Ted Arison, Chairman, along with his son Mickey Arison, President, and Bob Dickinson, Vice President of Sales and Marketing, began to alter the current approach to cruise vacations. Carnival targeted first-time cruisers and young people with a moderately priced vacation package that included airfare to the port of embarkation and airfare home after the cruise. Per-diem rates were very competitive with other vacation packages. Carnival offered passage to multiple exotic Caribbean ports, several meals served daily with premier restaurant service, and all forms of entertainment and activities included in the base fare. The only items not included in the fare were items of a personal nature, liquor purchases, gambling, and tips for the cabin steward, table waiter, and busboy. Carnival continued to add to the shipboard experience with a greater variety of activities, nightclubs, and other forms of entertainment. It also used multimedia-advertising promotions and established the theme of "Fun Ship" cruises, primarily promoting the ship as the destination and ports of call as secondary. Carnival told the public it was throwing a shipboard party and everyone was invited. Today, the "Fun Ship" theme still permeates all Carnival Cruise brand ships.

Throughout the 1980s, Carnival was able to maintain a growth rate of approximately 30%, about three times that of the industry as a whole. Between 1982 and 1988, its ships sailed with an average capacity of 104%. Targeting younger, first-time passengers by promoting the ship as a destination proved to be extremely successful. Carnival's customer profile showed that approximately 30% of passengers at that time were between the ages of 25 and 39, with household incomes of $25,000 to $50,000.

In 1987, Ted Arison sold 20% of his shares of Carnival Cruise Lines and immediately generated over $400 million for further expansion. In 1988, Carnival acquired the Holland America Line, which had four cruise ships with 4,500 berths. Holland America was positioned to appeal to higher-income travelers with cruise prices averaging 25%–35% more than similar Carnival cruises. The deal included two Holland America subsidiaries, Windstar Sail Cruises and Holland America Westours. This purchase allowed Carnival to begin an aggressive "superliner" building campaign for its core subsidiary. By 1989, the cruise segments of Carnival Corporation carried more than 75,000 passengers in one year, a "first" in the cruise industry.

Ted Arison relinquished the role of Chairman to his son Mickey in 1990, a time when the explosive growth of the industry began to subside. Higher fuel prices and increased airline costs began to affect the industry as a whole. The first Persian Gulf War caused many cruise

operators to divert ships to the Caribbean, increasing the number of ships competing directly with Carnival. Carnival's stock price fell from $25 in June of 1990 to $13 later in the year. The company also incurred a $25.5 million loss during fiscal 1990 for the operation of the Crystal Palace Resort and Casino in the Bahamas. In 1991, Carnival reached a settlement with the Bahamian government (effective March 1, 1992) to surrender the 672-room Riviera Towers to the Hotel Corporation of the Bahamas in exchange for debt cancellation incurred in constructing and developing the resort. The corporation took a $135 million write-down on the Crystal Palace that year.

In the early 1990s, Carnival attempted to acquire Premier Cruise Lines, which was then the official cruise line for Walt Disney World in Orlando, Florida, for approximately $372 million. The deal was never consummated because the involved parties could not agree on price. In 1992, Carnival acquired 50% of Seabourn, gaining the cruise operations of K/S Seabourn Cruise Lines, and formed a partnership with Atle Brynestad. Seabourn served the ultra-luxury market with destinations in South America, the Mediterranean, Southeast Asia, and the Baltic.

The 1993 to 1995 period saw the addition of the superliner *Imagination* to Carnival Cruise Lines and *Ryndam* for Holland America Lines. In 1994, the company discontinued the operations of Fiestamarina Lines, which had attempted to serve Spanish-speaking clientele. Fiestamarina had been beset with marketing and operational problems and had never reached continuous operation. Many industry analysts and observers were surprised at the failure of Carnival to successfully develop this market. In 1995 Carnival sold 49% interest in the Epirotiki Line, a Greek cruise operation, for $25 million and purchased $101 million (face amount) of senior secured notes of Kloster Cruise Limited, the parent of competitor Norwegian Cruise Lines, for $81 million. Carnival Corporation continued to expand through internally generated growth by adding new ships. Additionally, Carnival seemed to be willing to continue with its external expansion through acquisitions, if the right opportunity arose.

In June 1997, Royal Caribbean made a bid to buy Celebrity Cruise Lines for $500 million and the assumption of its $800 million debt. Within a week, Carnival had responded by submitting a counteroffer to Celebrity for $510 million and the assumption of debt. Two days later, Carnival raised the bid to $525 million. Nevertheless, Royal Caribbean announced on June 30, 1997, the final merger arrangements with Celebrity. The resulting company had 17 ships, with more than 30,000 berths.

Not to be thwarted in its expansion, Carnival announced in June 1997 the purchase of Costa, an Italian cruise company and the largest European cruise line, for $141 million. The purchase was finalized in September 2000. External expansion continued when Carnival announced the acquisition of the Cunard Line for $500 million from Kvaerner ASA on May 28, 1998. Cunard was then operationally merged with Seabourn Cruise Line. Carnival announced on December 2, 1999, a hostile bid for NCL Holding ASA, the parent company of Norwegian Cruise Lines. Carnival was unsuccessful in this acquisition attempt.

The terrorist attacks on New York's twin towers on September 11, 2001, caused tourists to cancel cruise plans and affected the leisure travel industry worldwide. It forced several smaller cruise line companies into bankruptcy while others reduced the size and scope of operations. Other competitors discounted cruise prices to maintain historic occupancy levels. Carnival was well positioned in the market and soon recovered once public fears subsided. It also made a focused effort to expand into the German and Spanish markets in Europe.

Consolidation in the industry continued in 2003 when Carnival and P&O Princess Cruises finalized an agreement to combine and created the first truly global cruise line. Carnival remained the parent company and added P&O Cruises, Ocean Village, AIDA, P&O Cruises Australia, and tour operator Princess Tours. The new Carnival now offered an ever expanding selection of price points, alternative destinations, and varied accommodations which allowed for even greater market penetration.

In 2007 Carnival sold Windstar Cruise Line to Ambassadors International Cruise Group and Swan Hellenic to Lord Sterling.

Carnival's Corporate Governance

Board of Directors

Exhibit 3A shows the 14 members of Carnival's Board of Directors, of whom three served as internal officers and four others were retired company employees or had previous ties to Carnival Corporation or one of its subsidiaries. Mickey Arison owned approximately one-third of the company's stock. (He also owned the Miami Heat, a basketball team which won the 2006 NBA Championship.) The Arison family and its trusts controlled roughly 36% of the stock. All other directors and executive officers, as a group, owned or controlled approximately 30% of the total shares outstanding.

According to the Board's by-laws, each outside director must own at least 5,000 shares of stock. Additionally, external board members are yearly granted 10,000 stock options, and are paid an annual retainer fee of $40,000 for serving on the Board. Fees are also paid for attending board and committee meetings.

Exhibit 3B lists Carnival's executive officers. **Exhibit 4** shows compensation for the key executives.

EXHIBIT 3A
Board of Directors

Mickey Arison
Chairman of the Board
and Chief Executive Officer
Carnival Corporation & plc

Sir Jonathon Band
Former First Sea Lord and Chief of Naval Staff British Navy

Robert H. Dickinson
Former President
and Chief Executive Officer
Carnival Cruise Lines

Arnold W. Donald
Former President
and Chief Executive Officer
Juvenile Diabetes Research Foundation International

Pier Luigi Foschi
Chairman and Chief Executive Officer
Costa Crociere S.p.A.

Howard S. Frank
Vice Chairman of the Board
and Chief Operating Officer
Carnival Corporation & plc

Richard J. Glasier
Former President
and Chief Executive Officer
Argosy Gaming Company

Modesto A. Maidique
President Emeritus and Professor of Management and Executive Director, FIU Center for Leadership
Florida International University

Sir John Parker
Chairman, National Grid plc, Chairman, Anglo American plc, and Vice Chairman, DP World (Dubai)

Peter G. Ratcliffe
Former Chief Executive Officer
P&O Princess Cruises International

Stuart Subotnick
General Partner
and Executive Vice President
Metromedia Company

Laura Weil
Chief Executive Officer
Urban Brands, Inc.

Randall J. Weisenburger
Executive Vice President
and Chief Financial Officer
Omnicom Group Inc.

Uzi Zucker
Private Investor

EXHIBIT 3B
Principal Officers

Mickey Arison
Chairman of the Board
and Chief Executive Officer

Howard S. Frank
Vice Chairman of the Board
and Chief Operating Officer

David Bernstein
Senior Vice President
and Chief Financial Officer

Richard D. Ames
Senior Vice President—Shared Services

Arnaldo Perez
Senior Vice President, General Counsel
and Secretary

Larry Freedman
Chief Accounting Officer
and Vice President–Controller

OPERATIONS SEGMENTS

AIDA CRUISES
Michael Thamm
President

CARNIVAL CRUISE LINES
Gerald R. Cahill
President and Chief Executive Officer

CARNIVAL AUSTRALIA
Ann Sherry AO
Chief Executive Officer
Carnival Australia

CARNIVAL UK
David K. Dingle
Chief Executive Officer

COSTA CROCIERE S.p.A.
Pier Luigi Foschi
Chairman and Chief Executive Officer
Gianni Onorato
President

HOLLAND AMERICA LINE
Stein Kruse
President and Chief Executive Officer

PRINCESS CRUISES
Alan B. Buckelew
President and Chief Executive Officer

SEABOURN CRUISE LINE
Pamela C. Conover
President and Chief Executive Officer

Corporate Organization

Headquartered in Miami, Florida, U.S.A., and London, England, Carnival Corporation is incorporated in Panama, and Carnival plc is incorporated in England and Wales. Fleet operations are worldwide with the majority of operations in the North American market and secondarily in Europe. The company's total worldwide share of the cruise line vacation market was at or above 50%, and distinctly higher in some geographically defined or segmented markets.

According to Carnival's investor relations site, Carnival Corporation & plc operated under a dual listed company structure whereby Carnival Corporation and Carnival plc functioned as a single economic entity through contractual agreements between separate legal entities. Shareholders of both Carnival Corporation and Carnival plc had the same economic and voting interest, but their shares were listed on different stock exchanges and not fungible. Carnival Corporation common stock was traded on the New York Stock Exchange under the symbol CCL. Carnival plc was traded on the London Stock Exchange under the symbol CCL and as ADS on the New York Stock Exchange under the symbol CUK. Carnival was the only company in the world to be included in both the S&P 500 index in the United States and the FTSE 100 index in the United Kingdom.

EXHIBIT 4

Annual Compensation: Carnival Corporation & plc

Name and Principal Position	Fiscal Year	Salary ($)	Bonus ($)	Stock Awards ($)	Option Awards ($)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings ($)	All Other Compensation ($)	Total ($)
Micky Arison	2009	880,000	—	4,772,807	930,546	2,206,116	255,581	496,513	9,541,563
Chairman of the	2008	880,000	—	5,561,856	1,538,673	—	112,718	404,329	8,497,576
Board & CEO	2007	850,000	—	3,689,123	1,879,529	2,925,000	69,875	336,688	9,750,215
David Bernstein	2009	450,000	83,915	274,181	91,013	383,585	—	107,269	1,389,963
Senior Vice	2008	350,000	155,860	107,122	128,795	428,260	—	105,088	1,275,125
President & CFO	2007	269,596	—	—	158,043	350,000	—	77,193	854,832
Gerald R. Cahill	2009	750,000	194,310	1,094,676	423,413	655,441	884,716	58,869	4,061,425
President and CEO	2008	750,000	—	708,717	569,727	1,162,288	675,536	48,775	3,915,043
of Carnival Cruise Lines	2007	625,000	—	168,248	654,499	1,000,000	343,435	42,841	2,834,023
Pier Luigi Foschi	2009	1,320,500	—	791,735	315,915	1,794,143	—	340,033	4,562,326
Chairman and CEO	2008	1,415,500	996,810	486,451	583,118	800,441	—	402,830	4,685,150
of Costa Crociere S.p.A.	2007	1,244,400	909,840	194,428	1,663,810	668,430	—	312,149	4,993,057
Howard S. Frank	2009	780,000	—	3,015,393	513,577	2,137,175	—	267,303	6,713,448
Vice Chairman of the	2008	780,000	—	2,893,800	827,976	2,709,400	3,899,136	355,255	11,465,567
Board & COO	2007	750,000	—	2,610,000	1,113,260	2,825,000	—	243,383	7,541,643

Mission

According to management, "Our mission is to deliver exceptional vacation experiences through the world's best-known cruise brands that cater to a variety of different lifestyle and budgets, all at an outstanding value unrivaled on land or at sea."

The 11 cruise lines competed in all of the three operational sectors of the cruise market (contemporary, premium, and luxury).

Operating Segments and Corporate Brands

Carnival Cruise Lines (www.carnival.com)

Carnival Cruise Lines was the most popular and most profitable cruise line in the world. Operating in the contemporary cruise sector, as of late 2010, Carnival operated 22 ships with a total passenger capacity of 54,480. Occupancy rates typically exceeded 100% on average, and the brand was the market leader in the contemporary segment of the industry. Carnival still utilized the theme of the "Fun Ships," and had embarked on a $250 million enhancement program of its eight fantasy-class ships. Carnival ships cruised to destinations in the Bahamas, Canada, the Caribbean, the Mexican Riviera, New England, the Panama Canal, Alaska, and Hawaii, as well as limited operations in Europe, with most cruises ranging from three to seven days.

Princess Cruises (www.princesscruises.com)

Princess Cruises offered a "complete escape" from daily routine. This segment operated 17 ships with a total passenger capacity of 37,588. Princess treated its passengers to world-class cuisine, exceptional service, and a myriad of resort-like amenities onboard, including the Lotus Spa, Movies Under the Stars, lavish casinos, nightclubs, and lounges. Princess was a pioneer in offering a choice of dining experiences so guests could dine when and where it was convenient. The Princess fleet cruised to all seven continents and boasted more than 280 destinations. Princess was classified in the industry as contemporary to premium. The company offered cruises ranging in length principally from 7 to 14 days.

Holland America Line (www.hollandamerica.com)

The Holland America Line was a leader in the premium cruise sector. Holland America operated a five-star fleet of 15 ships, with 23,484 passenger capacity. Holland America consistently set a standard in the premium segment with feature programs and amenities such as culinary arts demonstrations, greenhouse spas, and cabins with flat-panel TVs and Sealy plush-top Mariner's Dream beds. The company offered cruises from 7 to 21 days. Its ships sailed to more than 300 ports of call on all seven continents with more than 500 cruises per year.

Seabourn Cruises (www.seabourn.com)

Seabourn Cruise Line epitomized luxury cruising aboard each of its five intimate all-suite ships. The Yachts of Seabourn were lavishly appointed with virtually one staff member for every guest, to ensure the highest quality service. Typical cruises were from 7 to 14 days.

Costa Cruises (www.costacruises.com)

Costa Cruises was the leading cruise company in Europe and South America. Headquartered in Genoa, Italy, Costa offered guests on its 14 ships a multiethnic, multicultural, and multilingual ambiance. A Costa cruise was distinguished by its "Cruising Italian Style" shipboard ambiance. Costa's fleet cruised the Caribbean, the Mediterranean, Northern Europe, South America, Dubai, the Far East, and transoceanic crossings.

P&O Cruises (www.pocruises.com)

P&O Cruises was the largest cruise operator and the best-known contemporary cruise brand in the United Kingdom, and has cruised Australia for 78 years. The seven-ship main fleet and the three-ship Australian fleet offered cruises to the Mediterranean, the Baltic, the Norwegian Fjords, the Caribbean, and the Atlantic Islands, as well as Australia and the Far East. Total passenger capacity was approaching 20,000 for both operational fleets, and its principal market was the United Kingdom.

AIDA (www.aida.com)

AIDA was the best-known cruise brand in the fast-growing German cruise market. With its seven club ships and a capacity of over 12,000, AIDA offered cruises to the Mediterranean, the Baltic, the Norwegian Fjords, the Canary Islands, and the Caribbean. AIDA emphasized elements of the upmarket clubs and resorts in the premium and four-star range, and its facilities and activities attracted younger, more active vacationers.

Cunard Line (www.cunard.com)

The Cunard Line offered the only regular transatlantic crossing service aboard the world-famous ocean liner *Queen Mary 2* and the brand new *Queen Elizabeth*. Her equally famous retired sister, *Queen Elizabeth 2*, sailed on unique itineraries worldwide serving both U.S. and U.K. guests and still evoked memories of the grand days of ocean travel. The passenger capacity of the three Cunard ships was 6,700 (double occupancy), and Cunard's primary market was the United Kingdom and North America. The line proudly carried the legacy of the era of sophisticated floating palaces into the 21st century. These ships were classified in the luxury sector of the cruise market.

Ocean Village (http://www.oceanvillageholidays.co.uk)

Ocean Village was founded in 2004 in the United Kingdom. Its one ship sailed throughout the Mediterranean and the Caribbean, and targeted individuals in the 30 to 50 age range who liked to explore and wanted a change from traditional cruising. Although performance had been good, there have been indications that the ship may be transferred to the P&O brand at some future date.

IberoCruceros (www.iberocruceros.com/)

IberoCruceros was one of the top operators in the fast-growing Spanish and Portuguese language cruise markets. The company operated four ships with a berth capacity of 5,010. Ibero vessels operated in Mediterranean, Brazilian, Northern Europe, and Caribbean waters.

Industry Projections

The leisure cruise vacation industry has fared very well over the last 25 years, originating from transatlantic crossings and leisure cruises for the wealthy to being a staple vacation alternative for the middle class. Cruise Market Watch, a cruise vacation research company, estimated that all cruise lines will carry an annualized total passenger count worldwide of 18.4 million in 2010 and projected an increase to 21.3 million in 2013, a 15.7% increase from 2010. Giving perspective to the 2010 numbers, cruise travel accounted for less than half (50%) of all visitors to Las Vegas, when including all cruise ships, from all lines, filled to capacity all year long. Cruise companies can move ships to match demand patterns over the globe, while Las Vegas was a fixed destination.

According to Cruise Lines International Association's 2010 *Cruise Market Overview*, growth in the number of North American passengers (95% U.S. and 5% Canadian) was currently flat. Mickey Arison estimated the number of people in the United States that have taken a cruise at 20%. He based his estimate on the total U.S. population. Arison's estimate did not reflect the *core market*, the number of people who fit the cruiser potential profile: over 25, sufficient income, leisure time, and other factors. Cruise Market Watch estimated the core market at 130 million, and approximately 60 million individuals in the core market had taken a cruise. The North American market was a more mature market than other geographic markets internationally. Still, as of 2009, the North American market was the largest and was valued at $15.95 billion with Carnival holding a commanding 55% market share.

Despite the 2008–2009 current economic slump, industry growth worldwide had been between 5% and 8% per year due to the growth in the number of international passengers. This annual growth was expected to exceed that of the U.S. and Canadian market for the next several years. Europe's market was valued at $7.2 billion and the Asia/Australian markets combined was valued at $2.9 billion. Faster market growth combined with a weakening U.S. dollar would strengthen overseas earnings and create a greater focus to capture the fast growing markets. In these two market areas, as of 2009, Carnival held a 52% market share.

Industry capacity continued to increase (up 6.9% over 2009 capacity) and should continue through 2013. Industry occupancy (per ship) hovered between 102% and 104% in 2008–2009, depending on the market. Ticket prices and onboard spending should improve slightly in 2010 when compared to 2009, but still remain below 2008 levels. *Cruise Market Watch* estimated that average cruise revenue, per passenger, per diem for all cruise lines worldwide was projected to be approximately $208, of which $157 would be attributed to ticket price and $51 in onboard spending.

Advertising

According to the Nielsen Company, hospitality and total travel advertising expenditures showed a slight increase for the industry in 2009 over 2008 levels. Total industry advertising in 2008 of $3.89 billion was roughly a 4% increase over 2007. While hospitality firms such as Intercontinental Hotels, the Blackstone Group, and Southwest Airlines all increased advertising expenditures, Carnival Corporation decreased U.S. advertising expenditures as of January 2009 to $89.3 million, a 21% decrease from the previous calendar year. The brand with the greatest reduction in ad spending in the Carnival portfolio was Princess Cruises. *Hoover's* reported that, beginning in 2009, Carnival increased online and social media advertising utilizing Facebook, YouTube, Twitter, Flickr, and Podcasts, to allow for two-way conversations with consumers and also create brand fans.

Human Resources Management

Carnival Corporation's shore operations had approximately 10,000 full-time and 5,000 part-time/seasonal employees. Carnival also employed approximately 70,000 officers, crew, and staff onboard the 98 ships at any one time. Because of the highly seasonal nature of the Alaskan and Canadian operations, Holland America Tours and Princess Tours increased their workforce during the late spring and summer months in connection with the Alaskan cruise season, employing additional seasonal personnel. Carnival had entered into agreements with unions covering certain employee categories, and union relations were considered to be generally good. Nonetheless, the American Maritime union had cited Carnival (and other cruise operators) several times for exploitation of its crews.

Onboard service was labor intensive, employing help from almost 100 nations, many from third-world countries, with reasonable returns to employees. For example, waiters on a Carnival Cruise Lines ship could earn approximately $18,000 to $27,000 per year (base salary and tips), significantly greater than could be earned in their home countries for similar employment. Waiters typically worked 10 hours per day, 6–7 days per week, and had tenure of approximately eight years with the company. Even with these work parameters, applicants exceeded demand for all cruise positions.

Suppliers

The company's largest purchases were for travel agency services, fuel, advertising, food and beverages, hotel and restaurant supplies and products, airfare, repairs and maintenance, dry-docking, port facility utilization, and communication services. Most capital outlays were for the construction of new ships as well as upgrades and refurbishment of current ships. Although Carnival utilized a select number of suppliers for most of its food and beverages and hotel and restaurant supplies, most of these items were available from numerous sources at competitive prices. The use of a select number of suppliers enabled management to, among other things, obtain volume discounts. The company purchased fuel and port facility services at some of its ports of call from a limited number of suppliers. To better manage price fluctuations, the company hedged the price of fuel oil. In addition, the company performed major dry-dock and ship improvement work at dry-dock facilities in the Bahamas, British Columbia, Canada, the Caribbean, Europe, and the United States. Management believed there were sufficient dry-dock and shipbuilding facilities to meet the company's anticipated requirements.

Government Regulations

All of Carnival's ships were registered in a country outside the United States and each ship flew the flag of its country of registration. Carnival's ships were regulated by various international, national, state, and local port authorities' laws, regulations, and treaties in force in the jurisdictions in which the ships operated. Internationally, all ships and operations conformed to the SOLAS (Safety of Life at Sea) regulations adopted by most seafaring nations. In U.S. waters and ports, the ships had to comply with U.S. Coast Guard and U.S. Public Health regulations, the Maritime Transportation Security Act, International Ship and Port Facility Security Code, U.S. Oil Pollution Act of 1990, U.S. Maritime Commission, local port authorities, local and federal law enforcement agencies, and all laws pertaining to the hiring of foreign workers. All cruise ships were inspected for health issues and received a rating which was published on the Center for Disease Control (CDC) website for potential cruisers to review. Terrorist threats had tightened U.S. security of ports regarding docking facilities, cargo containers and storage areas, and crews requiring compliance with various Homeland Security agencies.

Sustainability

Carnival Corporation had adopted the requirements of International Standard ISO 14001:2004 for the environmental management systems of all subsidiary lines. It had internal policies concerning the reduction of the carbon and environmental footprint, energy reduction, shipboard waste management, environmental training of crew members, health, safety and security, and corporate social responsibility. The following excerpt from the Carnival Corporation investor relations website illustrates the commitment of Carnival Management.

> *". . . Carnival senior management maintains a continuing commitment to be responsible corporate citizens, especially when it comes to protecting the environment. We have made great strides in this*

area and will continue to dedicate our efforts toward even more progress. In 2009, we published our fourth annual Environmental Management Report. This action continues the expansion of our transparency in publicly reporting the details of our ongoing commitment to the environment. We have also begun to broaden the scope of our transparency to include sustainability reporting. Sustainability reports have been published by two of our brands, Costa and AIDA. We are planning to use these reports as models for similar sustainability reports by all of our brands, beginning in 2010."

Legal Issues

Carnival Corporation, like all cruise companies and hospitality providers, usually had several lawsuits pending at any point in time. Although consuming the time of corporate officers and sometimes requiring substantial financial remuneration, the principal danger of lawsuits results from the negative media publicity that may influence current and potential guests.

Some of the more publicized personal lawsuits came from passengers injured while onboard a Carnival vessel, sexual assaults by crewmembers or other passengers, negligence of the onboard medical staff, food contamination lawsuits, pay and working conditions lawsuits brought by crewmembers, and a host of other related court filings.

Legal issues for the company also tarnished its corporate image and reputation. Carnival had been sued by various entities for pollution, ship dumping of bilge and other waste contaminants in international and jurisdictional waters, and filing false statements with the U.S. Coast Guard. Fuel surcharges for passengers that were not part of the stated cruise fare and various other class-actions have also led to legal proceedings. The company had also been sued over copyright infringement in its production of entertainment shows and materials onboard ship.

Carnival attempted to aggressively protect its corporate reputation and brand image by attempting to minimize damage while ensuring that violations and actions were promptly corrected. Management wanted the company to be perceived as a responsible corporate citizen for guests, workers, and the world community.

Competitors

According to Cruise Lines International Association, there were several large cruise line companies worldwide and a host of smaller companies totaling more than 100 ships competing with the Carnival fleet. Carnival's primary competitors were Royal Caribbean, Disney, and Norwegian Cruise Line, although several other companies competed with Carnival brands in selected geographical markets and specific targeted cruise segments.

Royal Caribbean Cruises Ltd. operated five brands—Royal Caribbean International, Celebrity Cruises, Pullmantur, Azamara Cruises, and CDF Croisieres de France—and had a 50% joint venture with TUI cruises. Royal Caribbean operated 38 cruise ships with a passenger capacity of over 84,000. The company planned to add four new ships by 2012, bringing the capacity to 100,000 berths. The fleet visited approximately 400 destinations worldwide. The Royal Caribbean brand competed with the Carnival Cruise Lines brand and was perceived as being slightly more upscale than Carnival ships. It competed secondarily with Costa and other Carnival brands. Celebrity cruises competed in the premium segment against Carnival's Princess and Holland America brands. The Royal Caribbean company had a 27% market share in North America and a 22% share in the remaining world markets.

Disney Cruise Line, had two cruise ships, each having 877 staterooms (3,508 berths). Disney had its own private island, Castaway Bay, exclusive for Disney Cruise Line passengers, and catered primarily to family vacations. One analyst said, "Carnival should thank Disney for taking children off their ships." Specific areas of the ships were designated for activities preferred by adults, families, teens, and children. Disney Cruise Line used its ships primarily as a complement to its theme park vacations, and had a 2% market share in North America.

Norwegian Cruise Line had 11 ships with a berth capacity of over 23,000, and marketed "Freestyle Cruising," which allowed guests freedom of choice with regard to a multiplicity of dining venues and times. The atmosphere in the ships was "resort casual"; the fleet competed with Royal Caribbean and Carnival ships, and, to a lesser extent, brands targeted to the premium segment. The company was Hawaii's cruise leader. NCL had a market share of 10% of the North American Market and its affiliated companies had a small market share primarily in European markets.

Other Competitive Concerns

Carnival's management described the firm's competitors in the following manner:

First. Carnival competed with land-based vacation alternatives throughout the world including resorts, hotels, theme parks, and vacation ownership properties located in Las Vegas, Nevada, Orlando, Florida, various parts of the Caribbean and Mexico, Bahamian and Hawaiian Island destination resorts, and numerous other vacation destinations throughout Europe and the rest of the world.

Second. Carnival's primary cruise competitors in the contemporary and/or premium cruise segments for North American passengers were Royal Caribbean Cruise Ltd., Norwegian Cruise Line, and Disney Cruise Line. The three primary cruise competitors for European passengers were: (1) My Travel's Sun Cruises, Fred Olsen, Saga and Thomson in the United Kingdom; (2), Festival Cruises, Hapag-Lloyd, Peter Deilmann, Phoenix Reisen, and Tranocean Cruises in Germany; and (3) Mediterranean Shipping Cruises, Louis Cruise Line, Festival Cruises, and Spanish Cruise Line in Southern Europe. Carnival also competed for passengers throughout Europe with Norwegian Cruise Line, Orient Lines, Royal Caribbean International, and Celebrity Cruises.

Third. The company's primary competitors in the luxury cruise segment for the Cunard and Seabourn brands included Crystal Cruises, Radisson Seven Seas Cruise Line, and Silversea Cruises.

Fourth. Carnival brands also competed with similar or overlapping product offerings across all segments.

Financials

Stock

Like most corporations in the last five years, Carnival (CCL) stock had been a rollercoaster ride ranging from approximately $55 per share common to $17 and back to $42 as of the third quarter, 2010. With a beta of 1.51 the stock has moved parallel to both the DOW and S&P 500 but had underperformed both indexes. However, with a market cap of $33.51 billion and a forward P/E of 14.59, market analysts were generally recommending Carnival as a "hold" in October, 2010.

In 2006 the Board of Directors authorized the repurchase of $1 billion (maximum) of Carnival Corporation common stock and Carnival plc. A repurchase authorization of approximately $787 million was still in effect.

Because Carnival Corporation & plc operated under a dual listed company structure, an unusual "Stock Swap" arrangement had been created. Each year the Boards of Directors authorized the repurchase of a set dollar amount of Carnival plc ordinary shares and a set dollar amount of Carnival Corporation common stock shares under the "Stock Swap" program. The boards then used the "Stock Swap" program in situations where an economic benefit can be obtained because either Carnival Corporation common stock or Carnival plc ordinary shares were trading at a price that was at a premium or discount to the price of Carnival plc ordinary

shares or Carnival Corporation common stock, as the case may be. In effect, the company would sell overpriced stock in one company to buy undervalued stock in the other company.

Income and Balance Sheet

Cash dropped from $1.1 billion to $0.5 billion over the last five years and remained steady with a slight rise quarter over quarter during the third quarter of 2010. (See **Exhibits 5 to 7.**) Reflecting the increase in the number of ships ordered and going online, property and equipment steadily increased over the last five years from $21 billion to over $30 billion (3Q 2010). For this same reason, by 2009 long-term debt also increased from $5.7 billion to over $9 billion, but dropped to $7.6 billion by 3Q 2010.

Revenues had also seen a steady increase until the recession, but 3Q 2010 results indicated the company was on the road to recovery and could reach the net profits of 2008.

EXHIBIT 5
Consolidated Statements of Operations: Carnival Corporation & plc (Dollar amounts in millions, except per share data)

Year Ending November 30	2009	2008	2007
Revenues			
Cruise			
Passenger tickets	$ 9,985	$ 11,210	$ 9,792
Onboard and other	2,885	3,044	2,846
Other	287	392	395
	13,157	14,646	13,033
Costs and expenses			
Operating			
Cruise			
Commissions, transportation, and other	1,917	2,232	1,941
Onboard and other	461	501	495
Payroll and related	1,498	1,470	1,336
Fuel	1,156	1,774	1,096
Food	839	856	747
Other ship operating	1,997	1,913	1,717
Other	236	293	296
Total	8,104	9,039	7,628
Selling and administrative	1,590	1,629	1,579
Depreciation and amortization	1,309	1,249	1,101
	11,003	11,917	10,308
Operating income	2,154	2,729	2,725
Nonoperating (expense) income			
Interest income	14	35	67
Interest expense, net of capitalized interest	(380)	(414)	(367)
Other income (expense), net	18	27	(1)
	(348)	(352)	(301)
Income before income taxes	1,806	2,377	2,424
Income tax expense, net	(16)	(47)	(16)
Net income	$ 1,790	$ 2,330	$ 2,408
Earnings per share			
Basic	$ 2.27	$ 2.96	$ 3.04
Diluted	$ 2.24	$ 2.90	$ 2.95
Dividends declared per share		$ 1.60	$ 1.375

EXHIBIT 6
Consolidated Balance Sheets: Carnival Corporation & plc (Dollar amounts in millions, except par values)

Year Ending November 30		
Assets		
Current assets		
Cash and cash equivalents	$ 538	$ 650
Trade and other receivables, net	362	418
Inventories	320	315
Prepaid expenses and other	298	267
Total current assets	1,518	1,650
Property and equipment, net	29,870	26,457
Goodwill	3,451	3,266
Trademarks	1,346	1,294
Other assets	650	733
Total assets	$36,835	$33,400
Liabilities and shareholders' equity		
Current liabilities		
Short-term borrowings	$135	$256
Current portion of long-term debt	815	1,081
Convertible debt subject to current put option		271
Accounts payable	568	512
Accrued liabilities and other	874	1,142
Customer deposits	2,575	2,519
Total current liabilities	4,967	5,781
Long-term debt	9,097	7,735
Other long-term liabilities and deferred income	736	786
Commitments and contingencies		
Shareholders' equity		
Common stock of Carnival Corporation; $0.01 par value; 1,960 shares authorized; 644 shares at 2009 and 643 shares at 2008 issued	6	6
Ordinary shares of Carnival plc; $1.66 par value; 226 shares authorized; 213 shares at 2009 and 2008 issued	354	354
Additional paid-in capital	7,707	7,677
Retained earnings	15,770	13,980
Accumulated other comprehensive income (loss)	462	(623)
Treasury stock; 24 shares at 2009 and 19 shares at 2008 of Carnival Corporation and 46 shares at 2009 and 52 shares at 2008 of Carnival plc, at cost	(2,264)	(2,296)
Total shareholders' equity	22,035	19,098
Total liabilities and shareholders' equity	$36,835	$33,400

Although both revenues and profits had begun to recover, trends in ROA, ROI, gross profit margin, and net margin had steadily decreased over the last five years. Additionally, cost of goods sold as a percentage of revenues had shown a slow, but steady increase over the last five years. This increase had been partially offset by careful management of selling, general, and administrative expenses.

Geographic, Segment, and Cost

Exhibit 8 shows the revenues by geographic region. Although revenues across the board dropped in 2009, the percent of revenues from North America declined (−7.7%) with a corresponding increase in Europe (up 5.5%) and Others (up 2.3%).

EXHIBIT 7
Selected Ratios and Common-Sized Data: Carnival Corporation & plc

Selected Ratios	11/30/09	11/30/08	11/30/07	11/30/06	11/30/05
Return on assets	5.80	7.69	8.18	8.43	8.82
Return on invested capital	6.73	9.08	9.65	9.87	10.29
Cost of goods sold to sales	61.59	61.72	58.53	57.36	56.07
Net margin	13.60	15.91	18.48	19.25	20.36
From Common-Sized Income Statement					
Cost of goods sold	61.59%	61.72%	58.53%	57.36%	56.07%
Selling, general, & admin expenses	12.08%	10.94%	12.12%	12.22%	11.99%

SOURCE: *Tompson One Banker, October 28, 2010.*

EXHIBIT 8
Revenues by Geographic Area (Dollar amount in millions)

	Years Ended November 30		
	2009	2008	2007
North America	$ 6,855	$ 8,090	$ 7,803
Europe	5,119	5,443	4,355
Others	1,183	1,113	875
	$ 13,157	$ 14,646	$ 13,033

SOURCE: *Carnival Corporation & plc 2010 Annual Report, p. F 24.*

EXHIBIT 9
Revenue by Segment: Carnival Corporation & plc (Dollar amount in millions)

	Nine Months Ended August 31				
	Revenues	Operating Expenses	Selling and Administrative	Depreciation and Amortization	Operating Income
2010					
Cruise	$ 10,475	$ 6,306	$ 1,158	$ 1,019	$ 1,992
Tour and other	346	279	23	30	14
Intersegment elimination	(105)	(105)	—	—	—
	$ 10,716	$ 6,480	$ 1,181	$ 1,049	$ 2,006
2009					
Cruise	$ 9,698	$ 5,765	$ 1,142	$ 937	$ 1,854
Tour and other	373	316	24	27	6
Intersegment elimination	(120)	(120)	—	—	—
Total revenue	$ 9,951	$ 5,961	$ 1,166	$ 964	$ 1,860

SOURCE: *Carnival 2010 10-Q, p. 7.*

Carnival offered both cruises and tours. **Exhibit 9** shows the breakdown of revenues and cost for each segment. Cruises brought in the greatest revenue and had the least cost structure. Tours, although profitable, were offered primarily to enhance the cruise experience and differentiate one destination from another.

Exhibits 10 and **11** provide a further breakdown of costs associated with cruising and the dramatic impact fuel costs have on the net profitability.

EXHIBIT 10
Selected Cruise and Other Information: Carnival Corporation & plc

	Year Ending Three Months Ended August 31		Year Ending Nine Months Ended August 31	
	2010	**2009**	**2010**	**2009**
Passengers carried (in thousands)	2,617	2,485	6,888	6,383
Occupancy percentage (a)	111.1%	111.4%	106.2%	106.4%
Fuel consumption (metric tons in thousands)	838	807	2,473	2,359
Fuel cost per metric ton (b)	$ 473	$ 405	$ 489	$ 330
Currencies				
U.S. dollar to €1	$ 1.27	$ 1.41	$ 1.32	$ 1.37
U.S. dollar to £1	$ 1.52	$ 1.64	$ 1.54	$ 1.53

Notes:
(a) In accordance with cruise industry practice, occupancy is calculated using a denominator of two passengers per cabin even though some cabins can accommodate three or more passengers. Percentages in excess of 100% indicate that on average more than two passengers occupied some cabins.
(b) Fuel cost per metric ton is calculated by dividing the cost of fuel by the number of metric tons consumed.

SOURCE: *Carnival 2010 10-Q, p. 16.*

EXHIBIT 11
Selected Overall and ALBD* Expenses

(Dollar amounts in millions except ALBDS* and cost per ALBD)	Three Months Ended August 31		
	2010	**2010 Constant Dollar**	**2009**
	(in millions, except ALBDs and costs per ALBD)		
Cruise operating expenses	$ 2,160	$ 2,224	$ 2,081
Cruise selling and administrative expenses	373	384	372
Gross cruise costs	2,533	2,608	2,453
Less cruise costs included in net cruise revenues			
Commissions, transportation, and other	(517)	(542)	(515)
Onboard and other	(131)	(134)	(131)
Net cruise costs	1,885	1,932	1,807
Less fuel	(396)	(396)	(327)
Net cruise costs excluding fuel	$ 1,489	$ 1,536	$ 1,480
ALBDs	17,255,120	17,255,120	16,241,798
Gross cruise costs per ALBD	$ 146.84	$ 151.15	$ 151.07
Net cruise costs per ALBD	$ 109.24	$ 111.96	$ 111.29
Net cruise costs excluding fuel per ALBD	$ 86.28	$ 89.00	$ 91.16

Notes:
**ALBD* *stands for Available Lower Berth Day*

SOURCE: *Carnival 2010 10-Q, p. 18.*

Carnival in the Future

Carnival currently held approximately 50% of the cruising market. The company's strategy of "do one thing and do it better than anyone else" had been very successful. This concentration strategy had been so successful, in fact, that continued expansion in the cruise market was likely to become increasingly competitive and additional market share difficult to capture.

However, improving economic conditions may release pent-up demand for vacations with corresponding increase in the entire cruising market. An improving economy may be offset by increased terrorist activity in Europe and North America, a double dip recession, or rising fuel prices.

Carnival seemed to be positioned to take advantage of changes in the cruising industry by focusing more on Europe and differentiating with destinations, shipboard activities, and ship size. As Mickey Arison pondered the future of Carnival, his vision must extend many years into the future (ships must be ordered five or more years in advance) and attempt to forecast the world of 2016 and beyond to be successful.

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CASE 17

Chrysler in Trouble

Barnali Chakraborty, under the direction of Vivek Gupta

"For too long, Chrysler moved too slowly to adapt to the future, designing and building cars that were less popular, less reliable and less fuel efficient than foreign competitors."[1]

BARACK HUSSAIN OBAMA
PRESIDENT OF THE UNITED STATES, IN APRIL 2009

"More than anything the consumers are very hesitant to do business with a manufacturer in bankruptcy."[2]

PETER GRADY
EXECUTIVE AT CHRYSLER, IN MAY 2009

"This partnership (with Fiat SpA) transforms Chrysler into a vibrant new company with a wealth of strategic advantages. It enables us to better serve our customers and dealers with a broader and more competitive line-up of environmentally friendly, fuel-efficient high-quality vehicles."[3]

BOB NARDELLI
CHAIRMAN AND CEO OF CHRYSLER LLC, IN MAY 2009

Chrysler Files for Bankruptcy

ON APRIL 30, 2009, CHRYSLER MOTORS LLC (CHRYSLER), the third largest automobile manufacturer in the United States, filed for bankruptcy protection under Section 363[4] of Chapter 11[5] of the U.S. bankruptcy code in the Manhattan Bankruptcy Court along with its 24 wholly-owned U.S. subsidiaries. As part of its bankruptcy filing, Chrysler announced that it would establish a global strategic alliance with Fiat SpA (Fiat).[6] It would create a new company in which Fiat would initially have a 20% stake, which would later be increased up to 35%. The Voluntary Employees' Benefit Association (VEBA)[7] would have a 55% stake in it and the U.S. Treasury Department (U.S. Treasury) an 8% stake. The Canadian and Ontario governments would have a combined 2% stake, with the Canadian government holding 1.33% and the Ontario government holding the remaining 0.67% stake.

This case was written by Barnali Chackraborty, under the direction of Vivek Gupta, ICMR Management Research. It was compiled from published sources, and is intended to be used as a basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation. © 2009, ICMR Center for Management Research. This case cannot be reproduced in any form without the written permission of the copyright holders, Vivek Gupta and ICMR Management Research. Reprint permission is solely granted by the publisher, Prentice Hall, for the book *Strategic Management and Business Policy,* 13th Edition (and the international and electronic versions of this book) by the copyright holders, Vivek Gupta and ICMR Management Research. This case was edited for *SMBP,* 13th Edition. The copyright holders are solely responsible for case content. Any other publication of the case (translation, any form of electronic or other media) or sale (any form of partnership) to another publisher will be in violation of copyright law, unless Vivek Gupta and ICMR Management Research have granted additional written reprint permission. Reprinted by permission.

Chrysler was struggling to stay afloat even after receiving financial aid in the form of a federal loan of US$4 billion in January 2009, out of the requested amount of US$7 billion. However, with declining sales, it had become increasingly difficult for Chrysler to continue with its operations. Therefore, in its Restructuring Plan for Long-Term Viability, submitted on February 17, 2009, the company asked for another US$2 billion federal loan over and above the US$7 billion loan it had requested earlier. For Chrysler to get an additional federal loan, the U.S. government had made it a condition that the company should establish an alliance with Fiat on or before April 30, 2009. The company was also required to restructure its debt and negotiate with UAW (United Auto Workers)[8] and CAW (Canadian Auto Workers)[9] to reduce costs. Although Chrysler was able to reach an agreement with Fiat and had convinced UAW and CAW to reduce costs, it failed to get all its creditors to agree to debt restructuring. The company finally had to file for bankruptcy protection. Commenting on the company's bankruptcy filing, Bob Nardelli (Nardelli), Chairman and CEO of Chrysler, said, "Even though total agreement was not possible, I am truly grateful for all that has been sacrificed, on the part of many of Chrysler's stakeholders to reach an agreement in principle with Fiat. My number one priority has been to preserve Chrysler and the thousands of people who depend on its success. While I am excited about the creation of the global alliance, I am personally disappointed that today Chrysler has filed for Chapter 11. This was not my first choice."[10]

While some analysts were apprehensive about Chrysler's viability, others were of the view that Chrysler would come out of the bankruptcy soon. According to Lee Iacocca (Iacocca), former Chairman and Chief Executive Officer (CEO) of Chrysler, "It pains me to see my old company, which has meant so much to America, on the ropes. But Chrysler has been in trouble before, and we got through it, and I believe they can do it again."[11]

About Chrysler

The history of Chrysler can be traced back to the 1920s. In 1921, Walter P. Chrysler (Walter) joined as Chairman of Maxwell Motor Corporation (Maxwell).[12] During that time, Maxwell had high debts because of its declining sales after World War I.

In 1923, the production of automobiles under the brand name of Maxwell was stopped. In 1924, a new vehicle named Chrysler Six, which had a light, powerful, high-compression six-cylinder engine and the first ever four-wheel hydraulic brakes, was launched in the U.S. automobile market. The vehicle was available for US$1,565.

In 1928, the company acquired the Dodge Brothers firm and became the third largest automaker in the United States. The company also started the DeSoto and Plymouth divisions. The company positioned the Plymouth brand as a low priced car, while DeSoto was introduced in the medium price segment.

In 1934, the company introduced the Chrysler Airflow, one of the first cars to be aerodynamically designed. However, it was not able to generate much interest among the public. Nunetheless, the company was able to survive during the Great Depression[13] because of the strong sales generated by the entry-level Dodge and Plymouth brands.

In 1951, Chrysler developed the Firepower, the first hemispherical-head V8 engine, which later became popular as the HEMI® engine.[14] By the end of the 1950s, the company had become famous for creating power steering, power windows, the alternator, electronic fuel injection, and many other automotive innovations.

In the 1960s, Chrysler expanded into Europe and formed Chrysler Europe by acquiring the UK-based Rootes Group,[15] Simca,[16] and Barreiros.[17] In the 1970s, the company had to face new challenges such as issues related to environmental pollution and rising gas prices. It also started facing competition from foreign car manufacturers such as Honda Motor Company (Honda) and Toyota Motor Corporation (Toyota).

The oil crisis of the 1970s[18] resulted in a high demand for fuel-efficient cars. American customers started preferring small, fuel-efficient Japanese cars as compared to the U.S.-made bigger cars. Moreover, as the performance of the Japanese cars was superior to the cars made in the United States and their prices were competitive compared to the American cars, there was an increase in their sales.

In the 1970s, Chrysler's sales started declining. In 1978, the company hired Iacocca as the Chief Operating Officer (COO) of Chrysler Corporation. In September 1979, Iacocca was promoted to Chairman and CEO. Soon after, he carried out a revamping exercise in the company and set up a new management team.

Iacocca initiated several cost-cutting measures including scaling down nonproductive operations, closing down plants, stopping some employee benefits, initiating temporary layoffs, and so on. In the late 1970s, the company had a debt of approximately US$4.75 million and was in deep financial trouble. It had to ask for financial help from the U.S. government. In 1979, U.S. President Jimmy Carter signed a bill through which the U.S. government provided a US$1.5 billion federal loan to Chrysler Corporation. The federal loan helped the company restructure itself.

During the restructuring, Chrysler's product line was substantially expanded. Iacocca emphasized manufacturing passenger cars, like the Dodge Caravan and Plymouth Voyager, which received a good response from consumers. Apart from that, the company also focused on designing fuel-efficient K Cars.

By the early 1980s, Chrysler had started recovering from the crisis. In 1983, seven years ahead of schedule, the company repaid the federal loan. In 1984, the company reported a profit of US$2.4 billion.

Between 1984 and 1988, Chrysler acquired many companies including Gulfstream Aerospace Corporation, a corporate jet manufacturer; Lamborghini, the Italian luxury car manufacturer; Finance America; E. F. Hutton Credit Corporation; American Motors Corporation; and so on. Through the acquisition of American Motors Corporation, the world famous Jeep® brand came into the company fold. In 1987, the company increased its shareholding in Mitsubishi Motors Corporation and entered into a strategic alliance with Samsung, a South Korean electronics company.

In the late 1980s, the financial condition of Chrysler Corporation started deteriorating. The company began taking cost-cutting measures and introduced fuel-efficient vehicles like the Dodge Shadow and the Plymouth Sundance. In 1989, it started a US$1 billion cost-cutting and restructuring program. On December 31, 1992, Iacocca retired as the CEO of the company. In 1996, the company shifted to its new headquarters in Auburn Hills, Michigan, in the United States.

The Failed Merger with Daimler-Benz

In May 1998, Chrysler Corporation and Daimler-Benz AG (Daimler), a German automobile manufacturing company founded in 1926, agreed to combine their businesses in what they called a "merger of equals." On November 12, 1998, the merger process was completed. Through a deal worth US$37 billion, the new company was named DaimlerChrysler AG (DaimlerChrysler). Under DaimlerChrysler, Chrysler Corporation assumed its new name as DaimlerChrysler Motors Company LLC and its U.S. operations started being referred to as the Chrysler Group. The merger resulted in the world's third[19] largest automobile company in terms of revenues, market capitalization, and earnings and the fifth[20] largest in terms of number of units produced.

To avoid a clash between the German and American management styles, the Chrysler Group continued to manufacture mass market passenger cars and Daimler to build its luxury marquee Mercedes. In the third quarter of 2000–2001, the Chrysler Group reported a loss of

US$512 million, which resulted in a decline of share value to US$40 in September 2000 from US$108 in January 1999. After the merger, the market share of the Chrysler Group also fell from 16.2% to 13.5%. After the bad performance reported by the company, its two successive American presidents, James P. Holden and Thomas Stallkamp, were fired within a span of 19 months. Dieter Zetsche, a Daimler executive, was appointed as CEO of Chrysler and he appointed another Daimler executive, Wolfgang Bernhard, as the Chief Operating Officer (COO). According to the analysts, the sequence of events demoralized the employees of the Chrysler Group, which became a division of DaimlerChrysler and did not have any representative on the DaimlerChrysler board of management.

The merged entity started facing problems mainly because of the significantly different cultures of the two companies. While the Americans valued efficiency, empowerment, creativity, and informal relationships among the employees, the Germans followed more of a bureaucratic culture. Apart from cultural differences, other factors like differences in pay structures, different working styles, and so on, also played a critical role in creating a rift between the two companies.

For example, in Daimler, high disparities in pay package were discouraged and top management employees did not receive high incentives. In the American pay structure, however, the top executives were paid higher salaries and incentives.

The working styles of both the companies also differed significantly. While the Germans were used to having long meetings and submitting lengthy reports, the Americans preferred to spend less time on discussions. While the Americans preferred experimenting by following a trial and error method, the Germans had a comprehensive plan that they followed exactly.

In early 2007, DaimlerChrysler AG engaged in talks with Cerberus Capital Management L.P. (Cerberus)[21] to sell the Chrysler Group. In May 2007, it announced that it would sell an 80.1% stake of Chrysler to Cerberus for US$7.4 billion.

On May 21, 2007, Daimler announced that, as part of the deal of selling Chrysler to Cerberus, it would provide US$1 billion for Chrysler's pension plan, if the pension plan would be terminated within five years. Daimler assumed the responsibility of the pension payment as per the agreement between Chrysler and the U.S. Pension Benefit Guaranty Corporation (PBGC).[22] Commenting on Daimler's announcement, Vince Snowbarger, Interim Director of PBGC, said, "I commend both Daimler and Cerberus on their willingness to work with the PBGC to protect the retirement security of Chrysler workers and retirees. Both Daimler and Cerberus have made significant financial commitments to strengthen Chrysler pensions. Daimler has agreed to provide a guarantee of $1 billion to be paid into the Chrysler plans if the plans terminate within five years."[23]

In July 2007, the European Commission approved the pension deal. On August 6, 2007, Daimler sold off the majority stake to Cerberus. Chrysler became Chrysler Motors LLC (Chrysler) and DaimlerChrysler AG changed its name to Daimler AG. Nardelli was appointed as Chrysler's Chairman and CEO. Commenting on the deal, John Snow, the Chairman of Cerberus, said, "We are aware that Chrysler faces significant challenges, but we are confident that they can and will be overcome. A private investment firm like Cerberus will provide management with the opportunity to focus on their long-term plans rather than the pressures of short-term earnings expectations."[24]

In fiscal 2007, Chrysler reported an 8% growth in sales in markets outside the United States as compared to that of 2006. However, the sales in the U.S. market in 2007 declined by 3% compared to the previous year. Commenting on the strong growth in international sales, Jim Press (Press), Vice Chairman and President of Chrysler, said, "This is a revitalized organization, moving in the right directions, with a renewed emphasis on putting the global customer first at every step in the process—anxious to serve, proud of the value and quality of our products. I am pleased to say that our global results are beginning to show this."[25]

Chrysler Asks For Financial Aid

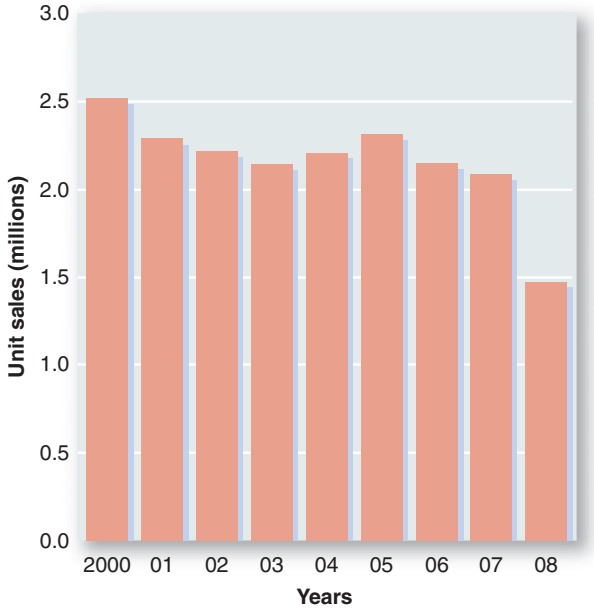
In 2007, Chrysler reported a net loss of US$1.6 billion. The company's financial problems continued in 2008, due to declining sales. (See **Exhibit 1** for Chrysler's annual U.S. sales between 2000 and 2008.)

In October 2008, Cerberus and General Motors Corporation (GM)[26] engaged in discussions regarding the merger of GM and Chrysler. Under the deal, it was proposed that GM would acquire Chrysler's automotive operations and Cerberus would get a 49% stake in General Motors Acceptance Corporation (GMAC).[27] However, the deal did not materialize.

In November 2008, Nardelli announced in the media that Chrysler required US$4 billion to run its operations until March 2009. Overall, Chrysler sought US$7 billion financial aid from the U.S. government. On December 17, 2008, Chrysler announced that on December 19, 2008, it would close its 12 North American plants due to weak demand. In December 2008, the sales figure of Chrysler declined by 54% as compared to the sales reported in the corresponding month of 2007.

On January 2, 2009, Chrysler received a US$4 billion federal loan. According to the terms of the loan, Chrysler had to submit a restructuring plan by February 17, 2009, for achieving long-term viability of its operations. On February 17, 2009, Chrysler submitted the restructuring plan to the U.S. Treasury and the U.S. Auto Task Force.[28] (See **Exhibit 2A and 2B** for Chrysler's restructuring plan.) In the plan, Chrysler made a request for an additional federal loan. The company said that, due to the worsening demand for its cars and trucks, it required a total of US$9 billion including the US$4 billion it had already received. The company wanted the loan by March 31, 2009, to continue with its operations. Commenting on Chrysler's request for an additional federal loan, Nardelli said, "We believe the requested working capital loan is the least-costly alternative and will help provide an important stimulus to the U.S. economy and deliver positive results for American taxpayers."[29]

EXHIBIT 1
Chrysler's Annual U.S. Sales (2000–06)



SOURCE: *Accessed from "Chrysler Bankruptcy Deal Revealed," http://news.bbc.co.uk, April 30, 2009.*

EXHIBIT 2A Highlights of the Three Alternatives Mentioned in Chrysler's Restructuring Plan for Long-Term Viability

STAND-ALONE PLAN

In its Stand-Alone Plan, Chrysler said,

- The company can be viable on a stand-alone basis in the short/midterm with the following assumptions:
  i. The balance sheet is restructured to substantially reduce current debt and debt servicing requirements;
  ii. Targeted concessions are obtained from all constituents;
  iii. Additional U.S. government funding of $5 billion and DOE 136 funding of $6 billion is secured; and
  iv. SAAR (Seasonally Adjusted Annual Rate) ≥ 10.1 million units.
- To be viable on a longer term basis, it is critical that Chrysler continues to pursue strategic partnerships/consolidation to be both operationally viable (i.e., meet energy and environmental regulations) and financially viable (i.e., create an acceptable ROI to shareholders and positive NPV).
- In a sustained U.S. industry below 9.1 M SAAR, we believe Chrysler LLC will struggle to remain viable and will require an additional restructuring and funding.

STRATEGIC PARTNERSHIP/CONSOLIDATION

In its Strategic Partnership/Consolidation Plan, Chrysler said,

- In all industry scenarios (SAAR levels), Chrysler will be more viable, both operationally and financially, with a strategic partner.
- Chrysler has signed a non-binding MOU with Fiat that will significantly enhance its viability by creating additional free cash flow over the 2009–2016 period and leverage the advanced powertrain and small car technology that has made Fiat number one in Europe in low CO_2 emissions.
- Fiat's proposal is contingent upon Chrysler LLC restructuring its debt, obtaining concessions, and receiving adequate government funding.
- In a sustained U.S. industry below 9.1 M SAAR, we believe even with Fiat, Chrysler LLC will struggle to be viable and will require additional restructuring and funding.
- Fiat alliance will create incremental jobs in the United States during the first five years compared with the Stand-Alone Plan.
- There exist further benefits from U.S. consolidation but no clear action path with GM.

ORDERLY WIND DOWN

In its Orderly Wind Down Plan, Chrysler said,

- If Chrysler LLC is not able to successfully:
  i. Restructure its balance sheet to substantially reduce its liabilities,
  ii. Negotiate targeted concessions from constituents,
  iii. Receive an additional $5 billion capital infusion from the U.S. government, as represented in the Stand-Alone Plan, then the only other alternative is for Chrysler to file for Chapter 11 as a first step in an orderly wind down.
- Chrysler LLC would seek debtor-in-possession financing from both private sector lenders and the U.S. government. We believe the estimated size of the financing need is US$24 billion over a two-year period.
- Without adequate DIP financing we estimate that the first lien lenders will only realize a 25% recovery, the U.S. government 5%, while all other creditors will receive nothing.
- An Orderly Wind Down will result in a significant social impact, with 300,000 jobs lost at Chrysler and its suppliers and over 3,300 dealers failing. Around 2–3 million jobs could be lost due to a follow-on collapse in the wider industry, resulting in a US$150 billion reduction in U.S. government revenue over 3 years.

SOURCE: *"Chrysler Restructuring Plan for Long-Term Viability," http://www.media.chrysler.com, February 17, 2009.*

EXHIBIT 2B Highlights of Chrysler Restructuring for Long-Term Viability

STRATEGIC ALLIANCE

Chrysler has signed a non-binding agreement to pursue a strategic alliance with Fiat that represents significant strategic and financial benefits to the stakeholders. The written and oral testimony Chrysler submitted to the U.S. House and Senate in 2008 stated the company's intent to seek the benefits of global partnerships and alliances. The proposed Fiat Alliance would enhance Chrysler's viability plan and would provide the company with access to competitive fuel-efficient vehicle platforms, distribution capabilities in key growth markets, and substantial cost-saving opportunities.

PRODUCTS

Chrysler's product line is a key component of its Viability Plan. In 2010, the company will launch four highly successful platforms: a new Jeep Grand Cherokee, a new Dodge Charger, a new Dodge Durango, and a new Chrysler 300 (the most awarded car in automotive history since its launch in 2005). The Chrysler 300 launch will be followed by a new, bolder Dodge Charger and an all-new unibody Dodge Durango.

In 2008, Chrysler offered six vehicles with highway fuel economy of 28 miles per gallon or better. For 2009, 73% of Chrysler LLC's vehicles showed improved fuel economy compared with the previous year's models. Fuel economy will continue to improve in 2010 with the introduction of the all-new Phoenix V6 engine, which will provide fuel-efficiency improvements of between 6% to 8% over the engines it replaces. A two-mode hybrid version of the company's best-selling vehicle, the Dodge Ram, is scheduled for 2010. The first Chrysler electric-drive vehicle is also scheduled to reach the market in 2010. It will be followed by other electric-drive vehicles, including Range-extended Electric Vehicles, in the following years in order to further reduce fuel consumption.

The proposed Fiat alliance would further help the company achieve these standards as Chrysler gains access to Fiat's smaller, fuel-efficient platforms and powertrain technologies. The alliance would enable Chrysler to reduce its capital expenditures while supporting the company's commitment to develop a portfolio of vehicles that support the country's energy security and environmental objectives.

RESTRUCTURING ACTIONS

Chrysler LLC has aggressively restructured operations to significantly improve cost competitiveness while improving quality and productivity. Through year end 2008, Chrysler has

- Reduced fixed costs by US$3.1 billion
- Reduced its workforce by 32,000 (a 37% reduction since January 2007)
- Eliminated 12 production shifts
- Eliminated 1.2 million units (more than 30%) of production capacity
- Discontinued four vehicle models
- Disposed of US$700 million in non-earning assets
- Improved manufacturing productivity to equal Toyota as the best in the industry as measured by assembly hours per vehicle according to the Harbour Report
- Achieved the lowest warranty claim rate in Chrysler's history
- Recorded the fewest product recalls among leading automakers in 2008

The following additional restructuring actions are planned in 2009:

- Reduce fixed costs by US$700 million
- Reduce one shift of manufacturing
- Discontinue three vehicle models
- Sell US$300 million additional non-earning assets

MANAGEMENT CONCESSIONS

- Chrysler will fully comply with the restrictions established under section 111 of EESA relative to executive privileges and compensation. In addition, the company has suspended the 401k match, incentive bonuses, and merit increases, and has eliminated retiree life insurance benefits.

(*Continued*)

EXHIBIT 2B Highlights of Chrysler Restructuring for Long-Term Viability (*continued*)

DEALER CONCESSIONS

- Chrysler will achieve cost savings/improved cash flow through a number of initiatives including reduced dealer margins, elimination of fuel fill, and reduction of service contract margins.

UNION CONCESSIONS

- The signed term sheets for the UAW Labor Modifications and VEBA modifications fundamentally comply with the requirements set forth in the U.S. Treasury Loan and once realized would provide Chrysler with a workforce cost structure that is competitive with the transplant automotive manufacturers. This agreement is subject to ratification.

SUPPLIER CONCESSIONS

- The company has initiated the dialogue with its suppliers and believes that it will be able to obtain substantial cost reductions from suppliers that will result in achieving targeted savings. Chrysler supports the supplier associations' proposals, which would provide a government guarantee of OEM accounts payables.

SECOND LIEN DEBT HOLDERS CONCESSIONS

- Chrysler anticipates that the holders of the Second Lien Debt will agree to convert 100% of their debt to equity. Chrysler's Viability Plan includes expectations to further reduce its outstanding debt by US$5 billion. In addition to strengthening the company's balance sheet for the long term, this reduction will provide immediate cash flow via interest savings of between US$350 million and US$400 million annually.

SOURCE: *"Chrysler LLC Viability Plan Submitted Today to the U.S. Treasury Department," http://www.chryslerllc.com, February 17, 2009.*

On March 30, 2009, the U.S. Treasury and the U.S. Auto Task Force rejected Chrysler's stand-alone Viability Plan. The U.S. Auto Task Force announced that it would provide another US$6 billion federal loan to Chrysler. However, in order to get the additional loan, Chrysler would have to form an alliance with Fiat by April 30, 2009. In addition, the company would have to restructure its debt and would have to negotiate with the UAW and CAW unions to reduce employee benefits and increase productivity.

In order to form an alliance with Fiat, in April 2009, Chrysler started the process of getting approval from its 45 lending institutions to surrender the first lien debt[30] of US$6.9 billion. It also entered into negotiations with UAW for it to accept a 55% equity stake in the new company in lieu of Chrysler's contribution to UAW's retiree health care trust fund, VEBA. The negotiations also included some adjustments to the UAW's 2007 collective bargaining agreement.

On April 21, 2009, the U.S. Treasury announced that it would give Chrysler US$500 million over and above the US$4 billion it had already given to continue its operations.

Meanwhile, on April 26, 2009, the CAW ratified an agreement it had reached with Chrysler in early April 2009. The agreement helped Chrysler to save US$240 million in annual costs. Giving details, Ken Lewenza, President of CAW, said, "Some of it comes from reduced compensation, some of it comes from lower legacy costs, some of it comes from increased productivity and efficiencies in the workplace."[31]

On April 28, 2009, the four largest creditor banks—JPMorgan Chase & Company,[32] Goldman Sachs Group Inc.,[33] Morgan Stanley,[34] and the Citigroup Inc.,[35] which collectively held 70% of Chrysler's total debt—approved the U.S. Treasury's offer of US$2 billion given to Chrysler's first lien debtors.

On April 29, 2009, the UAW also ratified the agreement it had reached with Chrysler. In the agreement, UAW agreed to have a 55% equity stake in the company after an alliance with

Fiat, instead of Chrysler's contribution in VEBA. UAW would also have a representative on the board of the new company.

However, the attempt to gain support from all the creditors was unsuccessful. About 20 financial firms including Oppenheimer Funds and Stairway Capital, who collectively held US$1 billion, declined to agree to the terms of the proposed debt restructuring. Analysts opined that the creditors might be better off after bankruptcy filing and liquidation of Chrysler's assets. They also opined that, in case of a bankruptcy filing by Chrysler, the creditors would have no choice but to accept the US$2 billion offered by the U.S. Treasury.

The U.S. government later offered the creditors another US$250 million, which made the total offering US$2.25 billion. However, the deal did not materialize. Criticizing the creditors, President Barack Obama said, "A group of investment firms and hedge funds decided to hold out for the prospect of an unjustified taxpayer-funded bailout. They were hoping that everybody else would make sacrifices and they would have to make none. Some demanded twice the return that other lenders were getting. I don't stand with them."[36]

The Bankruptcy

On April 30, 2009, Chrysler and its 24 wholly-owned U.S. subsidiaries filed for bankruptcy. However, Chrysler's Mexican, Canadian, and other international operations were not part of the bankruptcy filing. The company filed the bankruptcy under Section 363 so that it would be able to emerge from bankruptcy within 30 to 60 days. According to Obama, "It would be a very quick type of bankruptcy and they could continue operating and emerge on the other side in a much stronger position."[37]

As part of the bankruptcy filing, the U.S. Treasury was to give Chrysler a total of US$8 billion in additional aid including up to US$3.3 billion in debtor-in-possession (DIP)[38] financing and up to US$4.7 billion in exit financing.[39] Chrysler would have to repay the loan amount within the next eight years.

The financial arm of Chrysler was to be merged with GMAC, the finance arm of GM. During the bankruptcy period, the U.S. government was to back the warranty on Chrysler vehicles. Encouraging consumers to buy Chrysler products, Obama said, "No one should be confused about what a bankruptcy process means. This is not a sign of weakness, but rather one more step on a clearly charted path to Chrysler's revival."[40]

The new company would retain the Chrysler corporate name and would be run by a board of nine members including six members appointed by the U.S. government and three by Fiat. Nardelli was to resign as the CEO of Chrysler after the company emerged from bankruptcy and a new chief executive would be appointed.

As part of the bankruptcy, Cerberus and Daimler were to give up their respective equity stakes of 80.1% and 19.9% in Chrysler. In the new company, VEBA would have a 55% stake and Fiat a 35% stake. Of the remaining 10% equity stake in the new company, the U.S. Treasury would have 8% for the US$4.5 billion loan it had provided Chrysler. The Canadian and Ontario governments would have a combined 2% stake for the US$3.8 million provided to Chrysler—US$1.5 billion from the Ontario government and the remaining from the Canadian government. The creditors would receive US$2 billion for the US$6.9 billion they had lent to Chrysler.

On May 5, 2009, the company's bankruptcy was approved by the Manhattan Bankruptcy Court. Analysts welcomed Chrysler's decision to file for Chapter 11 bankruptcy. According to Aaron Bragman, Automotive Analyst at IHS Global Insight, "With all the major stakeholders accounted for and in agreement, such a bankruptcy could be theoretically accomplished much more easily than it otherwise would have been."[41]

The Chrysler-Fiat Alliance

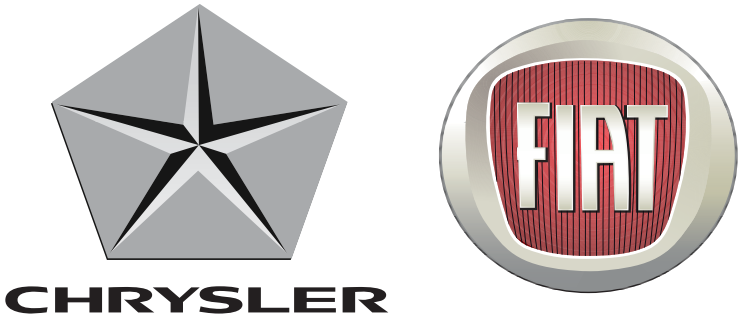
On May 5, 2009, Chrysler filed for bankruptcy. The company announced that it had reached an agreement to establish a global strategic alliance with Fiat. (See **Exhibit 3** for logos of Chrysler and Fiat.) The company also made a reference to all its efforts to enter into partnerships with different automobile companies, including GM, Volkswagen, Toyota, Honda, Nissan, and Hyundai. However, except for Fiat, no other options had been viable for it, the company said. Thomas LaSorda, Vice Chairman of Chrysler, said, "Despite continual efforts over the course of approximately two and a half years, no party except Fiat has emerged as a viable and willing alliance partner for us."[42]

As part of the alliance, Chrysler decided to sell all its assets to Fiat except eight factories: a sedan plant in Sterling Heights, Michigan; a St. Louis-area pickup-truck plant; a Dodge Viper sports car plant in Detroit; factories in St. Louis and Newark, Delaware; a metal stamping plant in Twinsburg, Ohio; an engine plant in Kenosha, Wisconsin; and an axle plant in Detroit. Commenting on the decision, Max Gates, spokesperson from Chrysler, said, "While some facilities may eventually close, none other than Newark and St. Louis South are scheduled for closure in the near term. Virtually all of the labor associated with these facilities will be offered employment with the new company."[43]

After the alliance was formed, the new company would be the world's sixth-largest car manufacturer. Commenting on the alliance with Fiat, Nardelli said, "Our viability for the long term would be enhanced even more by global strategic alliances and partnerships. The proposed Fiat alliance provides significant benefits to Chrysler. Fiat would make available to us its entire product portfolio and powertrain technology, worldwide distribution capabilities for vehicles we produce today, and synergies in the areas of purchasing and engineering, among others. We estimate the cash value of Fiat's contribution to be between eight and ten billion dollars considering the cost to develop these vehicles, platforms, and power trains from scratch."[44]

In the new company, Fiat was to initially have a 20% stake. Later, it could increase its stake by 15% in three stages of 5% each. Fiat was to increase the first 5% stake in the new company for providing a 40 mpg (miles per gallon) vehicle platform (i.e, assisting the new company to manufacture a vehicle which would give a mileage of 40 mpg.) The new vehicle would be produced in the United States. Fiat could increase its stake in the new company by another 5% after providing Chrysler a "fuel-efficient engine family" which would be produced in the United States and would be used in Chrysler vehicles. The third increase of a 5% stake would be for giving Chrysler access to Fiat's global distribution network. Fiat would not have to pay anything for its stake in Chrysler. It thus could increase its stake to 51% by 2016, after the new company had repaid the U.S. government's loan. Commenting on Chrysler's alliance

EXHIBIT 3
Logo of Chrysler and Fiat



SOURCE: *Tim O'Brien, "Bankrupt Chrysler U.S. Announces Alliance with Fiat," http://www.motorreport.com.au, May 01, 2009.*

with Fiat, Obama said, "It's a partnership that will give Chrysler a chance not only to survive, but to thrive in a global auto industry."[45]

With this alliance, Chrysler and Fiat would have access to each other's market. According to Pierluigi Bellini, an automotive analyst with IHS Global Insight, "Fiat has wanted to get back into the U.S. market for years, so this is a very good opportunity for them because it produces a quick entry."[46]

According to some analysts, the alliance between Chrysler and Fiat would not only help both the companies to access each other's market, but would also help to create jobs. According to a statement from Chrysler, the alliance would help the company to create or preserve more than 5,000 manufacturing jobs.[47] See **Exhibit 4** for synergies of the Chrysler-Fiat alliance mentioned in Chrysler's Restructuring Plan for Long-Term Viability. According to Sergionot Marchionne (Marchionne), Fiat, along with Chrysler, would be able to produce their first vehicle in the United States in early 2011.

EXHIBIT 4
Synergies of Chrysler-Fiat Alliance Mentioned in Chrysler's Restructuring Plan for Long-Term Viability

Area	Approach	Cash Flow Impact Total 2009–2016 (In US$ Billions)	EBITDA Impact Total 2009–16 (In US$ Billions)
Products/ Platform Sharing	2 million products localized or sold in NAFTA and exported to global markets	1.4	2.1
Distribution	New Chrysler markets adding 393,000 units, Alfa Romeo distributed in NAFTA	1.3	1.3
Purchasing	Integrate sourcing with Fiat Group	3.2	2.8
Other Opportunities	Powertrain, technology, logistics, SG&A expense, other funding for NSCs provided by Fiat	1.0	1.2
	Total Synergies*	**6.9**	**7.4**

Alliance with Fiat Benefits** (in US$ Billions)	2009	2010	2011	2012	2013	2014	2015	2016
EBITDA Synergy Benefits	0.0	0.0	0.3	1.2	1.3	1.5	1.6	1.5
Cash Synergy Benefits (cumulative)^	(0.1)	(0.1)	(0.2)	1.0	2.4	3.9	5.5	6.9

Notes:
* Synergies incremental to Chrysler only as calculated by Chrysler.
** A strategic alliance could reduce Chrysler's overall capital requirements and could create additional jobs in the United States. Additionally, the alliance would have the potential for better efficiency spending of DOE funds.
^ The negative cash impact in the first three years is due to spending approx US$1 billion in new platforms and powertrain technology offset by synergy savings.

SOURCE: *"Chrysler Restructuring Plan for Long-Term Viability," http://www.media.chrysler.com, February 17, 2009.*

What Went Wrong?

According to the analysts, the major reasons for Chrysler's present financial problems were its poor business strategy, lack of innovation, and the global financial crisis. According to David Lewis, professor at the University of Michigan's Ross School of Business, "In recent decades, it's had a more turbulent time, with more ups and downs than other automakers. Each decade, it seemed that Chrysler had a crisis."[48]

Chrysler failed to bring out new vehicles that met changing customer needs ahead of the competition. The global financial crisis[49] in 2008 only resulted in further deterioration of the company's financial health.

Poor Business Strategy

Analysts attributed Chrysler's financial problems to its poor business management. In the early 1970s, when fuel prices were going up and consumers in the United States started preferring fuel-efficient vehicles, Japanese companies like Toyota and Honda began coming out with compact and fuel-efficient cars to cater to these needs. However, Chrysler's focus remained more on SUVs and trucks, leaving the Asian carmakers to capitalize on this change in consumer preferences.

Other analysts criticized Chrysler's decision to merge with Daimler. According to Iacocca, "Eaton[50] panicked. We were making $1 billion a quarter and had $12 billion in cash, and while he said it was a merger of equals, he sold Chrysler to Daimler-Benz, when we should have bought them."[51]

Similar analysts also criticized Daimler's decision to run Chrysler as a stand-alone division. They opined that Daimler wanted to keep Chrysler separate from its luxury Mercedes-Benz marquee. By doing this, it did not take advantage of the benefits of developing vehicles together.

Lack of Innovation

According to analysts, Chrysler's sluggishness in launching innovative models when its Japanese competitors kept coming out with new designs resulted in the company's declining sales. Japanese companies continued to offer fuel-efficient vehicles, while Chrysler continued to produce fuel-guzzling trucks.

Chrysler, which had been the innovator of automatic transmission, power steering, and brakes, just did not live up to the consumer's expectations. Although it came up with some innovative products in the early 1980s, quality-related issues dented the brand image of its cars.

After the merger with Daimler, Chrysler introduced some new models. However, those models did not get much consumer attention. According to Jim Hall, Managing Director of 2953 Analytics of Birmingham, Michigan, "The truth is Daimler did them no favors. They approved products that previous Chrysler management wouldn't have approved if they were completely drunk and beaten crazy."[52]

Even after Cerberus bought a majority stake in Chrysler, the company could not invest enough money in research and development because of the declining sales of Chrysler's vehicles. The U.S. Auto Task Force also commented in March 2009 that "Chrysler's products have also historically underperformed in terms of quality, which remains a significant challenge. Unlike GM, which has had a number of successful recent product introductions and has developed a new global product development process that has promise, there are few tangible signs that Chrysler can reverse its share erosion."[53]

EXHIBIT 5
Chrysler U.S. Sales in April 2009

Sales	April 2009	April 2008	Volume Change (In %)	Four Months Ended April 2009	Four Months Ended April 2008	Volume Change (In %)
Car	15,563	39,564	−61	73,764	185,165	−60
Truck	61,119	108,187	−44	250,126	416,457	−40
Total	76,682	147,751	−48	323,890	601,622	−46

SOURCE: *"Chrysler LLC Reports April 2009 U.S. Sales," http://www.chryslerllc.com, May 1, 2009.*

The Global Financial Crisis

In 2008, the tight credit situation, volatility in the stock markets, problems in the U.S. housing market, increases in unemployment, and declines in incomes started affecting consumer spending. As a result, the U.S. car market was also badly affected. Those who wanted to purchase vehicles found it difficult to get loans or found the available financing too expensive.

In 2008, the U.S. auto industry experienced its worst year since 1992. The total sales of cars and light trucks were 13.2 million, a decline of 18% compared to 2007. The United States was the largest market for Chrysler. As of November 2008, "73 percent of its sales were from the U.S., 61 percent of its vehicles were produced in the country, 78 percent of its materials were purchased in the U.S. and 62 percent of its dealers were based in the U.S."[54]

As Chrysler's market was restricted to the United States alone, the global financial crisis which originated in the country affected its sales badly, leaving the company struggling to carry on its business. Chrysler reported a 48% decline in vehicle sales in the United States for the month of April 2009 as compared to the same month of 2008. In April 2009, Chrysler sold 76,682 units of vehicles in the United States. Its sales in April 2009 were also 24% less compared to the sales reported in March 2009. See **Exhibit 5** for Chrysler's U.S. sales in April 2009.

The Challenges

Industry analysts were also apprehensive about whether the small cars that the new company was to produce would be successful in the United States. According to Dennis DesRosiers, a Canadian Automotive Analyst, "First, Americans have to embrace smaller cars, which they never have. Second, they have to buy Italian small cars, which they never have. Third, Fiat/Chrysler has to find a way to make small cars profitable in North America, which no one, including the Japanese, has been able to do."[55]

Analysts were also worried about the rising competition in the car market. According to them, companies like Chevrolet, Ford, Toyota, and Honda had already launched their small car models in the United States. They were of the opinion that Fiat's entry into the United States, especially at the time of an economic slowdown, may not be a success. According to Eric Heymann, Auto Analyst at Deutsche Bank AG,[56] "Entering the U.S. market is not easy for anyone. Just look at how long it took the German or Japanese carmakers to be successful in the U.S."[57] Some analysts also worried about Chrysler being jointly owned by different entities such as the U.S. Government, Canadian Government, Ontario Government, UAW, and Fiat. They opined that, given the failed merger of Daimler and Chrysler, it would be difficult for all these entities to work together and repay the federal loan. According to Mirko Mikelic, portfolio manager at Fifth Third Bank,[58] "The biggest concern now is that the different stakeholders will be able to make the tough decisions they need to make."[59]

Although analysts were apprehensive about Chrysler's survival after the Fiat alliance, they were of the view that the alliance was still a better option than Chrysler trying to survive alone as this would just not be possible. According to Bob Corker, a Republican Senator from the U.S. state of Tennessee, "I have not seen a way that Chrysler makes it as a standalone entity. It's really a merger of two weaker entities, though I think it's better than Chrysler being on its own."[60]

On May 8, 2009, it was announced that Sergio Marchionne would be the chief of the new company after its alliance with Fiat was completed. Analysts were concerned about whether cultural issues would crop up after an Italian took charge of an American company. In April 2009, when asked about whether he would be the head of Chrysler after its alliance with Fiat, Marchionne said, "It's possible that I will have to divide my time between running Fiat and running Chrysler. Fundamentally, that's possible, but the title isn't important. What's important is that they hear me at Chrysler.[61] Analysts also wondered whether Marchionne could successfully run the new company or not. According to Karl Brauer, Editor In Chief of Edmunds.com,[62] "No matter how capable a businessman you are, taking on another car company that's been losing money for years and at the same time taking a bigger stake in an industry that's in freefall and has an uncertain future is a huge gamble."[63] Citing the poor performance of Chrysler, analysts expressed concern about the company's viability in the future. According to Capstone Advisory Group (Capstone),[64] Chrysler, which had lost US$16.8 billion in 2008, was expected to lose US$4.7 billion in 2009. Jeremy Anwyl, the Chief Executive of Edmunds.com, said, "The challenge is going to be for Chrysler to communicate some sort of a compelling reason to buy their products. What's the reason to consciously pick a Chrysler, Jeep, or Dodge over a competitive vehicle with all of this stuff (bankruptcy) going on?"[65]

However, Chrysler was optimistic about its future. Press said, "The industry appears to have stabilized, as it's been fairly level for the past four months. We know where the bottom is and, as the economy struggles to recover, vehicle sales should follow.[66] On May 7, 2009, Chrysler started a global corporate advertising campaign to restore confidence in the company among consumers. The campaign created by BBDO Detroit had TV ads with the tagline, "We're building a better car company . . . come see what we're building for you." The print ad had already started appearing in newspapers from May 3, 2009, under the headline, "We're building a better car company." From May 11, 2009, the ad was shown on network primetime television. The first 30-second spot, called "Bright Future," showed the strength of Chrysler and how it was restructuring itself and had finalized its alliance with Fiat. The second 30-second spot, called "Open Road," showed its products and their features.

Commenting on the advertisement campaign, Steve Landry, Chief of Chrysler Sales and Marketing, said, "We want to establish a level of trust and confidence that customers can still buy cars and trucks from us and it is business as usual. We are working to exit bankruptcy as fast as we can."[67] He added, "When we asked consumers what they wanted to know about Chrysler, they told us to tell them about our products, tell them why they should buy our vehicles, and give them a reason why they should be confident in the future of this company. We believe this campaign delivers on all of those objectives."[68]

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3. Tim O'Brien, "Bankrupt Chrysler U.S. Announces Alliance with Fiat," http://www.motorreport.com.au, May 1, 2009.
4. Section 363 refers to the section of the U.S. Bankruptcy Code that allows a company to enter a court supervised process to sell assets quickly as the best means to protect value for the benefit of its stakeholders. Unlike a typical bankruptcy proceeding,

which can often take a few years to resolve, the advantage of 363 bankruptcy is speed. Through the 363 process, a company is able to emerge from bankruptcy in approximately 30 to 60 days (Source: http://www.chryslerrestructuring.com).

5. Chapter 11 of the United States Bankruptcy Code permits reorganization under the bankruptcy laws of the U.S. It can be filed by any business, whether a corporation or a sole proprietorship, although it is mostly used by corporate entities. A Chapter 11 debtor usually proposes a plan of reorganization to keep its business alive and pay creditors over time.
6. Founded in 1899, Fiat SpA is an Italian automobile manufacturer headquartered in Turin, Italy. For the fiscal 2008, the company earned revenues of €59.4 billion.
7. The Voluntary Employees' Beneficiary Association (VEBA) under Internal Revenue Code section 501(c)(9) of Internal Revenue Service of the United States Department of the Treasury is an organization organized to pay life, sick, accident, and similar benefits to members or their dependents, or designated beneficiaries. Members of this organization must be individuals who are employees who have an employment-related common bond. This common bond may be a common employer (or affiliated employers), coverage under one or more collective bargaining agreements, membership in a labor union, or membership in one or more locals of a national or international labor union. VEBA allowed a company to make tax free contributions into the fund, which is later used to pay benefits to its employees. The main aim of setting up this organization was to ensure the employees continued to get benefits even if the company got into financial trouble. (Source: http://www.irs.gov)
8. UAW was founded in 1935. As of 2008, it was one of the largest labor unions in North America.
9. CAW, one of the largest labor unions in Canada, was founded in 1985.
10. "Chrysler LLC and Fiat Group Announce Global Strategic Alliance to Form a Vibrant New Company," http://www.chryslerllc.com, April 30, 2009.
11. Tom Krisher and Stephen Manning, "Chrysler Succumbs to Bankruptcy After Struggle," http://news.yahoo.com, April 30, 2009.
12. Maxwell Motor Corporation was founded in 1904.
13. The Great Depression that started in 1929 refers to the economic slump in North America and Europe. The effects of the depression were felt across the world and it lasted till the late 1930s. The Great Depression resulted in a major fall in stock prices, which adversely affected individuals, financial institutions, and banks, leading to the closure and insolvency of several banks. This led to reduced demand, spending, and production, and to increased unemployment.
14. A Chrysler Hemi engine, known by the trademark Hemi, is an internal combustion engine built by Chrysler that utilizes a hemispherical combustion chamber. A hemispherical (i.e., bowl-shaped) combustion chamber allows the valves of a two valve-per-cylinder engine to be angled rather than side-by-side. This creates more space in the combustion chamber roof for the use of larger valves and also straightens the airflow passages through the cylinder head (Source: http://en.wikipedia.org).
15. The Rootes Group is a British automobile manufacturer. It was founded in 1913. Chrysler acquired the Rootes Group in 1967.
16. Simca was a French automaker and marquee, founded in 1934. In 1958, Chrysler bought a 15 percent stake in it. Later, in 1970, the company was acquired by Chrysler.
17. Barreiros was a Spanish manufacturer of engines, trucks, buses, tractors, and automobiles. The company was founded in 1954. It was acquired by Chrysler in 1969 (Source: http://en.wikipedia.org).
18. In 1973, the Yom-Kippur war also known as The October War, broke out between Israel and some of its Arab neighbors, when Israel attacked Egypt and Syria. Oil supply was disrupted because of the war and the oil prices jumped from US$ 3 to US$ 12 per barrel. The rise in oil prices resulted in an increase in gasoline prices in the U.S. from 38.5 cents per gallon in May 1973 to 53.1 cents per gallon in June 1974. In order to reduce fuel consumption, the U.S. government imposed a 55 miles per hour speed restriction on vehicles.
19. In 1998. the world's first two largest automobile companies in terms of revenues were General Motors and Ford Motor Company.
20. In 1998, the world's four largest automobile company in terms of number of units produced were General Motors, Ford Motor Company, Toyota, and Volkswagen respectively.
21. Cerberus Capital Management is a private equity firm; headquartered in New York, the U.S. It was founded in 1992.
22. The Pension Benefit Guaranty Corporation (or PBGC) is an independent agency of the U.S. government that was created by the Employee Retirement Income Security Act of 1974 (ERISA) to encourage the continuation and maintenance of voluntary private defined benefit pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at the lowest level necessary to carry out its operations (Source: http://en.wikipedia.org).
23. "Daimler Assumes $1 Billion Chrysler Pension Plan Risk." http://in.reuters.com, May 21, 2007.
24. Chris Isidore, "Daimler Pays to Dump Chrysler," http://money.cnn.com, May 14, 2007.
25. "Chrysler LLC Announces 2007 Global Sales; International Markets Results Best in Company's History: Minivan Reign Continues," http://www.chryslerllc.com, January 2009.
26. General Motors Corporation (GM), a multinational automobile manufacturer, was founded in 1908. It is headquartered in Detroit, Michigan, the U.S. In the fiscal 2008, it reported a revenue of US$ 148.979 billion and a net loss of US$ 30.9 billion.
27. General Motors Acceptance Corporation (GMAC) was started in 1919 to finance car buyers. It sold commercial and automotive financing, real estate services, and insurance and mortgage products. In 2006, GM sold 51 percent stake of GMAC to Cerberus Capital Management in 2006.
28. On February 16, 2009, Barack Hussein Obama, the President of the U.S., launched the U.S. Auto Task Force, to oversee the restructuring of the U.S. auto industry.
29. Chris Isidore, "GM, Chrysler Ask For $ 21.6 Billion More," http://money.cnn.com, February 18, 2009.
30. First lien debt is the highest priority debt in the case of default. If a property or other type of collateral is used to back a debt, first lien debt holders are paid before all other debt holders. (Source: http://www.investorwords.com)
31. "Chrysler, CAW Reach Deal To Save Company $240m A Year," http://www.cbc.ca, April 24, 2009.
32. JPMorgan Chase & Company is a U.S.-based, leading global financial services firm. It was formed in 2000, after the merger when Chase Manhattan Corporation acquired JP Morgan & Company. As of December 31, 2008, it reported a net revenue of US$ 67,252 million and a net profit of US$ 5,605 million.
33. Goldman Sachs Group, Inc is a bank holding company that is engaged in investment banking, securities services, and

investment management. For the fiscal year 2008, the company reported revenues of US$ 53.579 billion and net income of US$ 2.322 billion (Source: http://en.wikipedia.org).

34. Morgan Stanley is a US-based global financial services provider. It acts as a financial advisor to companies, governments, and investors from across the world. For the fiscal year 2008, it reported a net revenue of US$ 62.262 billion and a net income of US$ 1.707 billion (Source: http://www.morganstanley.com).

35. Citigroup Inc. is an international financial conglomerate with operations in consumer, corporate, investment banking and insurance. For the fiscal 2008, it reported total revenues of US$ 52.793 billion and net loss of US$ 27,684. (Source: http://www.citigroup.com).

36. "Chrysler Bankruptcy Deal Revealed." http://news.bbc.co.uk, April 30, 2009.

37. "Chrysler Approaches Key Deadline," http://news.bbc.co.uk, April 30, 2009.

38. Debtor-in-possession (DIP), under the United States bankruptcy law, is a person or corporation who has field a bankruptcy petition, but remains in possession of property upon which a creditor has a lien or similar security interest. DIP financing is a special form of financing provided for companies in financial distress or under Chapter 11 bankruptcy process. The specialty of DIP financing is that it gets priority over existing debt, equity, and other claims (http://en.wikipedia.org).

39. Exit financing in bankruptcy is the funding that is given to a bankrupt company to come out of bankruptcy. In order to get exit financing, the company requires to prepare a plan of reorganization which has to be supported by all of its creditors. If the bankruptcy court also agrees to the plan, then the company can come out of bankruptcy with the exit financing.

40. Clare Trapasso and Larry Mcshane, "Despite Bankruptcy, Chrysler Still Has Fans Who Say Car Company Will Survive." http://www.nydailynews.com, April 30, 2009.

41. IHS Global Insight is the global leader in economic and financial analysis forecasting and market intelligence. As of 2008, it had more than 3,800 clients in industry, finance, and government. (Source: http://www.globalinsight.com)

42. "In Fiat, Chrysler Has a Simpatico Dance Partner," http://www.mydigitaltc.com. May 5, 2009.

43. Mike Ramsey, "Chrysler Plans to Leave Eight Factories in Bankruptcy," http:www.bloomberg.com. May 1, 2009.

44. "Chrysler Has 30 Days to Reach Deal with Fiat: Report," http://economictimes.indiatimes.com, April 30, 2009.

45. "Chrysler Bankruptey Deal Revealed," http://news.bbc.co.uk, April 30, 2009.

46. Ronald Jones, "Can Marchionne's Magic Work At Chrysler?" http://www.msnbc.msn.com, May 1, 2009.

47. Mike Ramsey, "Chrysler Plans to Leave Eight Factories in Bankruptcy," http://www.bloomberg.com, May 1, 2009.

48. Christine Tierney, "Chrysler's History Full of Crisis, Comebacks," http://www.detnews.com. May 1, 2009.

49. The global financial crisis of 2008–09 was an ongoing major financial crisis that affected all countries across the world. The crisis was triggered when sub-prime mortgages were offered to borrowers without a proper check being done on whether they would be able to repay the loan or not. When several of these borrowers defaulted, there was a ripple effect in the U.S. economy. The financial crisis became prominent from mid-2008 with the failures of several large U.S.-based financial firms. Soon, it started affecting financial markets of other countries also.

50. Robert Eaton was the Chairman and CEO of Chrysler Corporation between 1993 and 1999.

51. "How Daimler, Chrysler Merger Failed," http://www.pressbox.co.uk, May 18, 2007.

52. Tom Krisher, "Without a Big-Selling Design in Works. Chrysler in Trouble," http://www.bnet.com, November 2, 2008.

53. "Chrysler Faces Challenging Future: White House," http://www.livemint.com, March 30, 2009.

54. "Testimony of Robert Nardelli to the U.S. Senate," http://www.chryslerllo.com, November, 2008.

55. John Ivison, "Chrysler's Key Problem Remains," http://www.nationalpost.com, May 2, 2009.

56. Deutsche Bank AG was founded in 1870. It is a Germany-based financial services provider. As of 2008, it reported revenue of US$ 13.490 billion and net loss of US$ 3.896 billion.

57. Jorn Madslien, "Can Fiat Put Chrysler on Road to Recovery?" http://news.bbc.co.uk, May 1, 2009.

58. Fifth Third Bank was incorporated as Bank of the Ohio Valley in 1858. It is a U.S.regional banking corporation, headquartered in Cincinnati, Ohio (Source: http://en.wikipedia.org).

59. "Chrysler Files for Bankruptcy. CEO To Quit," http://ibnlive.in.com. (April 30, 2009.)

60. "Chrysler Chiefs Battle to Avoid Bankruptcy," http://www.mydigitalfc.com, March 17, 2009.

61. "Fiat Chief Marchionne Will Head Chrysler," http://timesofindia.indiatimes.com, May 8, 2009.

62. Edmunds.com, headquartered in Santa Monica, California, was founded in 1966. It is a provider of automotive information via websites, books, and other media (Source: http://en.wikipedia.org).

63. Ronald Jones, "Can Marchionne's Magic Work At Chrysler?" http://www.msnbc.msn.com, May 1, 2009.

64. Capstone Advisory Group, LLC provides solutions for stakeholders, lenders and investors dealing with distressed and fraud situations, for parties in commercial disputes, and for lenders and investors evaluating capital transactions. (Source: http://www.capstonecr.com)

65. Nick Bunkley, "Sick Chrysler Optimistic Despite Crash," http://business.theage.com.au, May 3, 2009.

66. "Chrysler LLC Reports April 2009 U.S. Sales," http://www.chryslerllc.com, May 1, 2009.

67. "Chrysler to Launch Ad Campaign to Reassure Nervous Buyers," http://www.domain-b.com, May 4, 2009.

68. "Chrysler LLC Launches New Global Corporate Advertising Campaign." http://www.chryslerrestructuring.com, May 7, 2009.

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CASE 18

Tesla Motors Inc. (Mini Case)

J. David Hunger

We believe that more than 100 years after the invention of the internal combustion engine, incumbent automobile manufacturers are at a crossroads and face significant industry-wide challenges. The reliance on the gasoline-powered internal combustion engine as the principal automobile powertrain technology has raised environmental concerns, created dependence among industrialized and developing nations on oil largely imported from foreign nations and exposed consumers to volatile fuel prices. In addition, we believe the legacy investments made by incumbent automobile manufacturers in manufacturing and technology related to the internal combustion engine have to date inhibited rapid innovation in alternative fuel powertrain technologies. We believe these challenges offer an historic opportunity for companies with innovative electric powertrain technologies and that are unencumbered with legacy investments in the internal combustion engine to lead the next technological era of the automotive industry.

THUS BEGAN THE *INVESTORS OVERVIEW* PAGE OF TESLA MOTORS' website in September 2010. (See www.teslamotors.com.) The company had just completed an initial public offering (IPO) of 11,880,600 shares of its common stock plus a private sale of an additional 2,941,176 shares to Toyota Motor Corporation at the initial price of $17.00 per share. Management intended to use the proceeds to purchase an existing automobile factory in Fremont, California, from NUMMI, the joint venture between Toyota and Tesla Motors Liquidation Company, the owner of General Motors' interest in this plant, and to fund the expansion of retail stores. With Elon Musk, the founder of PayPal, as its CEO, the company had developed and successfully sold over 1,200 electric-powered Roadsters as of July 1, 2010. *Advertising Age* had named Tesla one of *America's Hottest Brands* in 2009—even though the company did no advertising and relied instead on the Internet, word-of-mouth, and presentations by CEO Musk.

Selling at $101,000 in the United States, the Tesla Roadster had become the darling of celebrities like Jay Leno and David Letterman. Introduced in 2008, this electrically powered auto could accelerate from 0 to 60 miles per hour (mph) in 3.9 seconds and cruise for 236 miles on a single charge. *Motor Trend* found in its December 2009 road test that the Roadster recorded 0 to 60 mph in 3.70 seconds and completed the quarter mile in 12.6 seconds, reaching 102.6 mph. Engineering Editor Kim Reynolds called the acceleration "breathtaking." The

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December 14, 2008, episode of the British television program *Top Gear* found that the Roadster was not only "biblically quick," but also that it completed the test track with a score similar to that recorded by the Porsche 911 GT3. According to *Top Gear*'s Jeremy Clarkson, the car was an "astonishing technical achievement."

The air-cooled electric motor weighed less than 70 pounds, but generated 248 horsepower with no engine noise and no exhaust emissions. Instead of gasoline, it required electricity stored in 6,831 lithium-ion batteries that were recharged by plugging them into an electric outlet. It was a true *green machine*. The Roadster's battery-to-wheel motor efficiency was 92% on average and 85% at peak power, contrasted with the gas tank-to-wheel efficiency of internal combustion engines at about 15%. Tesla's management reported an energy cost of approximately one U.S. cent per mile when charging the car at night. A full-recharge of the battery system required 3 1/2 hours using Tesla's 70 amp, 240 volt electrical connection. The Tesla Roadster set a new world distance record of 313 miles on a single charge for a production electric car in a rally across Australia as part of the *2009 Global Green Challenge*. Based on the attractive Lotus Elise sports car, the Tesla Roadster single-handedly destroyed the notion held by many people at the time that electric cars had to be slow in acceleration and awkward in appearance.

History

Originally conceived by Martin Eberhard and Marc Tarpenning, the Tesla Roadster began to take shape when Elon Musk took an active role in the company starting in early 2004. He oversaw the Roadster's product design and expanded the company's strategic goals to include marketing mainstream vehicles. The company originally licensed AC Propulsion's EV Power System design and Reductive Charging patent. Tesla then re-designed and built its own advanced battery pack, power electronics module, high efficiency motor, and extensive control software so that its powertrain was unique and no longer required a license from AC Propulsion. The electric powertrain had fewer moving parts than an internal combustion engine. In July 2005, Tesla signed an agreement with British sports car maker Lotus for help in chassis development. Body panels were made from resin transfer molded carbon fiber composite to minimize weight.

The company signed a production contract in 2007 with Group Lotus to produce a total of 2,400 "gliders" (partially assembled vehicles) in its plant in Hethel, England. For Roadsters bound for customers in North America, the gliders were sent to Tesla's plant in Menlo Park, California, for final assembly with the powertrain. For Roadsters being sold elsewhere in the world, the gliders received their powertrain at a facility near the Lotus Hethel plant. As of March 2010, Tesla had purchased 1,200 gliders. The contract with Lotus was scheduled to run out in December 2011, but the Roadsters would continue being made in 2012 until the supply of gliders from Lotus was exhausted. The next generation of the Tesla Roadster was to be manufactured in Tesla's new Fremont, California, facilities.

In August 2007, Martin Eberhard was replaced as CEO by interim CEO Michael Marks, who was then replaced in December 2007 by Ze'ev Drori as CEO. In October 2008, Elon Musk succeeded Drori as CEO and Chairman of the Board. Even though Musk was a key part of Tesla's progress, he was not a full-time CEO. Musk also served as CEO and Chief Technology Officer of Space Exploration Technologies, a developer and manufacturer of space launch vehicles, and as Chairman of SolarCity, a solar equipment installation company. Tesla's top management team was quite new. Three of the five members of senior management, including the CFO and VP of Manufacturing, had joined the company between 2008 and 2010.

Business Model

According to the company's *Prospectus*, Tesla Motors designed, developed, manufactured, and sold high-performance fully electric vehicles and advanced electric vehicle powertrain components. The company intentionally departed from the traditional automotive industry model by both exclusively focusing on electric powertrain technology and by owning its own vehicle sales and service network. Tesla Motors was the first company to commercially produce a federally compliant highway-capable electric vehicle. Management believed that the company's core intellectual property contained within its electric powertrain would form the foundation for its planned future electric vehicles. Since the management team combined the innovation and speed-to-market characteristics of Silicon Valley firms with the engineering experience of leading automotive companies, they believed that the company would be able to rapidly and efficiently introduce additional vehicles, such as the planned Tesla Model S sedan, and stay at the forefront of the automobile industry.

In contrast to existing auto manufacturers who sold their cars through franchised dealers, Tesla intended to sell and service its cars through the Internet and through its own Tesla stores. This was being done in order to reduce costs, to provide a better experience for Tesla customers, and to incorporate customer feedback more quickly into the product development and manufacturing processes. By June 2010, Tesla had opened 12 Tesla stores in major metropolitan areas throughout the United States and Europe. Management planned to open 50 stores globally within the next several years in connection with the Model S introduction. Consequently, the company hired former Apple and Gap executive George Blankenship to be Vice President of Design and Store Development in July 2010. According to CEO Musk in a press release, "George has a record of building customer-focused stores that revolutionize their industries, and he does it on time and on budget. . . . With George's leadership, I have no doubt Tesla will have the best retail experience in the auto industry as we continue to grow and prepare to launch the Model S." Tesla stores were the service hub for Tesla Rangers, the mobil service program that provided house calls for service.

In its *Prospectus*, management stated that it was designing a Model S four-door, five-passenger premium sedan that "offered exceptional performance, functionality and attractive styling with zero tailpipe emissions" at an effective price of $49,900 in the United States (assuming continuation of the $7,500 tax credit to alternative fuel vehicles). The company intended to begin volume production at its new Fremont, California, plant in 2012 with a target annual production of approximately 20,000 cars. The Model S would offer ranges from 160 to 300 miles on a single charge. It was designed to be charged at home and at commercial charging stations. The Model S would serve as an adaptable platform so that it could be used to develop a full line of other vehicles, including a product line at lower prices than the Model S.

In addition to making and selling its own autos, Tesla Motors sold its battery packs and chargers to other auto companies. It developed a relationship with Daimler to sell 1,000 battery packs and chargers in 2009 to Daimler's Smart Fortwo electric drive. Daimler then extended the order to 1,500 more packs and chargers. This was followed by a 2010 agreement for Daimler to purchase battery packs and chargers for its A-Class of electric vehicles being introduced during 2011. In May 2010, Tesla and Toyota Motor Corporation formally agreed to cooperate in the development of electric vehicles, beginning with an electric version of Toyota's popular RAV4. In exchange, Tesla would receive Toyota's support in sourcing parts and production and engineering expertise for the Model S. As a result of these agreements, Tesla management planned to expand its electric powertrain production facility in Palo Alto, California, to develop and market powertrain components to Daimler, Toyota, and other auto manufacturers.

Auto Industry

By late 2010, most automobile manufacturers were in the process of developing their own versions of the electric car. General Motors was launching its electric Volt for about $41,000 less federal tax rebates. To combat "range anxiety," the Volt contained a gasoline engine that would run the electric motor when the batteries ran low after 40 miles. Nissan was also introducing its all-electric Leaf, a $33,600 compact that would average 100 miles on a charge. Daimler was leasing an all-electric version of its SmartCar. In addition, BMW, Chrysler, Ford, Toyota, and Mitsubishi were introducing electric models within a year or so. Industry analysts were projecting that, following an expected increase in the world's population from 6.8 billion to 9 billion people by 2050, the number of autos will rise from 800 million to 1.1 billion. According to Frost & Sullivan, the market for electric-based vehicles (including electric, hybrid electric, and plug-in hybrid electric vehicles) was expected to grow approximately 10.6 million globally, or to approximately 14% of new vehicles sold by 2015, from 1.75 million units or 3% of new vehicles sold in 2008.

A number of factors would determine the success of the electric auto. One was the high level of unemployment and economic anxiety due to the "great recession" of 2008–2009. In the short run, potential consumers were likely to be very cost conscious and less willing or able to use credit to purchase a new durable product, like a major appliance or an automobile. An electric or hybrid electric auto generally cost more than a comparable gasoline-powered car. Auto companies were aware that it will take some time for customers to become accustomed to the vagaries of regenerative braking that slows the car as soon as the foot is lifted off the accelerator. (In those situations when the car is fully charged, however, no regenerative braking is needed, and the car does not slow down until the brakes are applied.)

It was widely acknowledged in the industry that a key limiting factor was current battery technology. Recharging batteries took much longer than did refilling a gas tank. Charging an auto via a standard U.S. 110-volt outlet might take 8 to 12 hours. (The Nissan Leaf's low price included a 110-volt charging system, but could be upgraded to a 220-volt system by paying $700 more.) Charging time could be reduced to 4–8 hours by installing a 240-volt outlet in the garage. Another factor influencing electric car sales was "range anxiety," a driver's concern with running out of power while far from a recharging station. The effective range of an electric car was a function of how hard the car was driven and the amount of electricity needed to power the headlights, dash lights, radio, heater, and air conditioner, plus heated seats and other power-consuming amenities. In addition, the batteries were likely over time to lose their capacity to hold a charge. Tesla Motors estimated that its battery pack will retain about 60%–65% of its ability to hold its initial charge after approximately 100,000 miles and 7 years.

A key influencing factor was the battery pack, which took up a significant amount of space and added weight—thus affecting carrying capacity and handling. For example, the battery pack took up the entire backseat of BMW's Mini Cooper electric car. *Top Gear's* 2008 road test of the Tesla Roadster versus the Lotus Elise, upon which it was based, found the Tesla to be less capable and much slower in turns than was the Lotus, even though the Tesla was the faster car. Battery packs were also very expensive. The Nissan Leaf's battery pack, for example, cost about $15,000, half the car's selling price. In addition, lithium-ion batteries had a history in laptop computers of heating up and sometimes failing. Even though auto makers were designing their battery pack so that any single cell's sudden release of energy would not spread to adjacent cells, there was always the possibility of battery pack failure. *Consumer Reports* reported that loud battery cooling fans in the Tesla Roadster emitted a constant roar of noise. Nevertheless, as electric car technology advanced, the price, carrying capacity, and durability of electric cars was expected to improve—thus increasing the size of the market.

From the perspective of Tesla Motors, existing auto makers faced significant hurdles in successfully competing in the electric car market. Even though GM and Toyota had each invested over $1 billion in hybrid and plug-in electric vehicle programs, they continued to invest in internal combustion technology because of their need to support their existing revenue base and core competencies. The need of existing car makers to investigate multiple alternative power technologies, such as hydrogen fuel cell, clean diesel, and natural gas powertrains, had inhibited their ability to develop electric powertrain technology. Recent deteriorating margins reduced flexibility and constrained auto companies' liquid capital resources. Profitability pressures were further exacerbated by the typically expensive and time-consuming new product development process.

Tesla Motors' Strategic Position

Tesla's management argued that, due to their proprietary electric powertrain system, their company had a competitive advantage over existing auto makers. For example, Tesla vehicles were designed with greater range and recharging flexibility and were more efficient to operate than were the electric cars of competitors. In addition, the Tesla Roadster offered high performance without compromising design or functionality. Management pointed to the company's many strengths:

- Leadership in electric power technology. The Tesla Roadster had a battery pack capable of storing 53 kilowatt hours of usable energy, almost double the energy of any other commercially available electric vehicle battery pack;
- Competencies in electrical engineering, software, and controls as well as vehicle engineering and manufacturing;
- Ability to combine electric powertrain expertise with electric vehicle design and systems integration;
- Rapid customer-focused product development;
- Ownership of its sales and service network;
- Brand leadership in high-performance, long-range electric vehicles;
- Long-term financial support from a $465 million loan facility agreement under the U.S. Department of Energy's Advanced Technology Vehicles Manufacturing Incentive Program; and
- Efficient research & development process. Cumulative capital expenditures and R&D for the Tesla Roadster totaled only $125 million.

Tesla's management also admitted that the company had weaknesses and faced significant risks. For one thing, even though its total revenues had increased from $73 million in 2007 to $14.7 billion in 2008 to $111.9 billion in 2009, the company had never earned a profit. Its net losses had varied from $78.2 billion in 2007 to $82.8 billion in 2008 to $55.7 billion in 2009. For the first six months of 2010, revenues had increased to $49.2 billion from $47.8 billion during the same period in 2009. If battery pack and charging equipment sales of $4.7 billion to Daimler had not been included, however, 2010 six-month revenue from auto sales would have only been $44.6 billion. For the same six-month period, net losses increased from $26.9 billion in 2009 to $68.0 billion in 2010, primarily due to a tripling of both R&D and selling, general, and administrative expenses. The company also incurred $45.4 billion in long-term debt in 2010 compared to none in 2009.

Tesla's management admitted that the rate at which the company incurred losses was expected to increase significantly as it developed and manufactured the Model S, continued R&D on its electric power train, equipped its manufacturing facilities, opened new Tesla stores, expanded its service and repair facilities, and increased its marketing and its general and administrative functions to support growing operations. For example, one of the risks in selling autos through the Internet or through company-owned retail stores was that many U.S. states prohibited auto manufacturers from selling directly to consumers without the use of an independent dealership or a physical presence in the state. As of 2010, the company was registered as both a manufacturer and dealer in California, Colorado, Florida, Illinois, and Washington, and licensed as a dealer in New York. Management also admitted that they had no experience to date in high volume manufacturing and did not know if they would be able to develop efficient, automated, low-cost manufacturing capabilities and processes, as well as reliable sources of component supply. Even though Tesla Motors purchased 30% of its parts from North American suppliers, 40% from European suppliers, and 30% from Asian suppliers, the company was reliant upon a few single source suppliers. For example, Sotira Composites Group supplied all carbon fiber body panels, BorgWarner supplied all gearboxes, and Lotus was the only supplier of the Roadster glider. Other risks abounded. Even though none of the Tesla employees were unionized in 2010, in-house manufacturing using the Fremont facility purchased from NUMMI might result in a workforce inclined to form a union.

The Future

By September 2010, Tesla Motors had finalized the design of the Model S, built prototypes of the Model S battery and powertrain, and released design specs to external parts suppliers. Its new VP of Design and Store Development was expanding Tesla's distribution and service network. All powertrain manufacturing had been centralized in Tesla's new corporate headquarters in Palo Alto, California. In order to manufacture both its Roadster and new Model S in-house, the company had successfully purchased the old NUMMI manufacturing facility—located just 20 miles from Tesla's headquarters. Even though the company's stock price had first surged and then fallen from its initial IPO price of $17, a Tesla share of stock was worth $19.56 at the September 23, 2010, stock market close. The firm appeared to be on track to achieve its goal of staying at the forefront of the electric automobile industry by building a full line of electric vehicles. Although it was unlikely that the company would become profitable in the next few years, management continued to be optimistic about the future of Tesla Motors.

Industry analysts cautioned, however, that no new company has been able to successfully enter the U.S. auto manufacturing industry since the 1920s. Would Tesla Motors be an exception? Now that the large global auto corporations were developing their own versions of the electric car, would it only be a matter of time before they caught up with Tesla's technology lead and surpassed it? Companies like GM, Toyota, and Ford had major advantages over Tesla in resources, brand identity, economies of scale, and distribution. A technological advance in battery power, size, and weight could completely alter the competitive landscape. How could Tesla Motors defend itself against the entire industry and not only become profitable, but also a major player in a very competitive global industry?

CASE 19

Harley-Davidson Inc. 2008:

THRIVING THROUGH A RECESSION

Patricia A. Ryan and Thomas L. Wheelen

We fulfill dreams through the experience of motorcycling by providing to motorcyclists and to the general public an expanding line of motorcycles, branded products and services in selected market segments.[1]

HARLEY-DAVIDSON MISSION STATEMENT

IT WAS A PRETTY AMAZING SIGHT, DOZENS AT A TIME, THOUSANDS IN A DAY DESCENDING ON THE Sinclair gas station and Western café in Lusk, Wyoming, on their way to the 2008 Sturgis rally in the blistering heat of early August. Lusk, a town of 1,348 people that lies 147 miles southwest of Sturgis, saw bikers from all walks of life, needing fuel and small supplies, some with tattoos, some with leather to protect themselves from the winds as they cruised at 60 miles per hour along Highway 18 toward Sturgis. Some clearly were businessmen on a weeklong reprieve, others were rougher in appearance. The one thing they all had in common was the love of the ride . . . the ride of the Harley-Davidson motorcycle.

There were new issues facing Harley-Davidson in their 105th year of operation. Consider the weak dollar, the probability that retail sales would continue a downward spiral, which in turn would cause excess inventory of high priced motorcycles. Then there was the customer base: the rockers who grew up in the sixties and seventies are graying and this threatens the growth of Harley-Davidson. As riders approach sixty, it is important for Harley-Davidson to recruit new riders of the younger generations. Their emphasis on recruiting women has been instrumental in recent years. They were faced with an aging baby boomer population and needed to focus on growing smaller segments of their business—women bikers and younger bikers, the latter who could not traditionally afford a Harley-Davidson motorbike.

Many things were looking good for the 105-year-old motorcycle manufacturer; however, President and CEO James Ziemer needed to continue the company's strong growth as many economists felt the economy was heading into a recession. Harley-Davidson had opened their first dealership in mainland China, and named Beijing Feng Huo Lun as the first authorized dealer. A Harley-Davidson museum was due to open in 2008 and sought to attract upwards of

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350,000 tourists per year. CEO and President Ziemer worked his way up the ranks, starting 38 years ago as a freight elevator operator and most recently serving a 14-year stint at CFO, but now at the driver's seat, he faced a different set of responsibilities. As noted by one analyst,

> *There are indications that Harley-Davidson is at a turning point. "It's a well managed company with still one of the strongest brand names in consumer products, but I just question whether the company can grow its production 7 to 9 percent in an environment where demand doesn't seem to be growing at that rate"*
>
> Ed Aaron, *analyst with BRC Capital Markets*[2]

History[3]

In 1901, William Harley (age 21), a draftsman, and his friend, Arthur R. Davidson, began experimenting with ideas to design and build their own motorcycles. They were joined by Arthur's brothers, William, a machinist, and Walter, a skilled mechanic. The Harley-Davidson Motor Company started in a 10 × 15 foot shed in the Davidson family's backyard in Milwaukee, Wisconsin.

In 1903, three motorcycles were built and sold. The production increased to eight in 1904. The company then moved to Juneau Avenue, which is the site of the company's present offices. In 1907, the company was incorporated.

Ownership by AMF

In 1969, AMF Inc., a leisure and industrial product conglomerate, acquired Harley-Davidson. The management team expanded production from 15,000 in 1969 to 40,000 motorcycles in 1974. AMF favored short-term profits instead of investing in research and development and retooling. During this time, Japanese competitors continued to improve the quality of their motorcycles, while Harley-Davidson began to turn out noisy, oil-leaking, heavy vibrating, poorly finished, and hard-to-handle machines. AMF ignored the Japanese competition. In 1975, Honda Motor Company introduced its "Gold Wing," which became the standard for large touring motorcycles. Harley-Davidson had controlled this segment of the market for years. There was a $2,000 price difference between Harley's top-of-the-line motorcycles and Honda's comparable Gold Wing. This caused American buyers of motorcycles to start switching to Japanese motorcycles. The Japanese companies (Suzuki and Yamaha) from this time until the middle 1980s continued to enter the heavyweight custom market with Harley look-alikes.

During AMF's ownership of the company, sales of motorcycles were strong, but profits were weak. The company had serious problems with poor quality manufacturing and strong Japanese competition. In 1981, Vaughn Beals, then head of the Harley Division, and 13 other managers conducted a leveraged buyout of the company for $65 million.

Under New Management

New management installed a Materials As Needed (MAN) system to reduce inventories and stabilize the production schedule. Also, this system forced production to work with marketing for more accurate forecasts. This led to precise production schedules for each month, allowing only a 10% variance. The company forced its suppliers to increase their quality in order to reduce customer complaints.

Citicorp, Harley's main lender, refused to lend any more money in 1985. On New Year's Eve, four hours before a midnight that would have meant Harley's demise, the company inked

a deal with Heller Financial that kept its doors open. Seven months later, amid a hot market for new stock, Harley-Davidson went public again. Ziemer, the CFO puts it more bluntly: "You throw cash at it, try to grow too fast, you'd destroy this thing."[4]

During the time Harley-Davidson was a privately held firm, management invested in research and development. Management purchased a Computer-Aided Design (CAD) system that allowed the company to make changes in the entire product line and still maintain its traditional styling. These investments by management had a quick payoff in that the break-even point went from 53,000 motorcycles in 1982 to 35,000 in 1986.

During 1993, the company acquired a 49% interest in Buell Motorcycle Company, a manufacturer of sport/performance motorcycles. This investment in Buell offered the company the possibility of gradually gaining entry into select niches within the performance motorcycle market. In 1998, Harley-Davidson owned most of the stock in Buell. Buell began distribution of a limited number of Buell motorcycles during 1994 to select Harley-Davidson dealers. Buell sales were:[5]

Year	Sales	Units (thousands)
1994	$ 6 million	576
1995	$14 million	1,407
1996	$23 million	2,762
1997	$40 million	4,415
1998	$53.5 million	6,334
1999	$63.5 million	7,767
2000	$58.1 million	10,189
2001	$61.9 million	9,925
2002	$66.9 million	10,900
2003	$76.1 million	10,000
2004	$79.0 million	9,900
2005	$93.1 million	11,200
2006	$102.2 million	12,460
2007	$100.5 million	11,513

Buell's mission "is to develop and employ innovative technology to enhance 'the ride' and give Buell owners a motorcycle experience that no other brand can provide." The European sport/performance market was four times larger than its U.S. counterpart. In 2007, there were 804 dealerships that sold Buell bikes dealerships worldwide. Most of these dealerships were combined Harley-Davidson and Buell dealerships.

In 1995, the company acquired substantially all of the common stock and common stock equivalents of Eaglemark Financial Services, Inc., a company in which it held a 49% interest since 1993. Eaglemark provided credit to leisure product manufacturers, their dealers, and customers in the United States and Canada. The transaction, valued at $45 million, was accounted for as a step acquisition under the purchase method.

Concentration on Motorcycles

In 1996, the company announced its strategic decision to discontinue the operations of the Transportation Vehicles segment in order to concentrate its financial and human resources on its core motorcycle business. The Transportation Vehicles segment was composed of the Recreation Vehicles division (Holiday Rambler trailers), the Commercial Vehicles division (small delivery vehicles), and B & B Molders, a manufacturer of custom or standard tolling and injection-molded plastic pieces. During 1996, the company completed the sale of the Transportation Vehicles segment for an aggregate sales price of approximately $105 million; approximately $100 million in cash and $5 million in notes and preferred stock.

Internal Makeover and New Products

In 1997, Harley-Davidson created an internal makeover. The unsung hero of Harley-Davidson's supply-chain makeover was an intense procurement expert named Garry Berryman, vice president of Materials Management/Product Cost from 1995 to 2003 at Honda. When Berryman joined Harley-Davidson, he found the supply-chain management neglected. There were nine different purchasing departments operating from different plant locations, fourteen separate sets of representative terms and conditions, and nearly 4,000 suppliers. Engineers with little or no expertise in supply management were doing the bulk of the buying. To top it off, "the voice of supply management was buried three layers deep in the corporate hierarchy," said Berryman.

While at Honda, Berryman studied Japanese keiretsu—huge, vertically integrated companies that foster deep, trusting relationships with suppliers. He wanted to form similar strategic alliances with Harley's top suppliers, bringing them into the design and planning process. Berryman felt that new technology and the Internet would make it easier than ever to form these bonds and collaborate. He made it clear that relationship and strategy should drive applications, not vice versa. As Dave Cotteleer, the company's manager of planning and control, explained, "We're using technology to cut back on communication times and administrative trivia, like invoice tracking, so we can focus the relationships on more strategic issues. We're not saying, 'Here's a neat piece of technology. Let's jam it into our model."[6]

Also, in the 1990s, Harley-Davidson saw the need to build a motorcycle to appeal to the younger and international markets who preferred sleeker, faster bikes. Harley-Davidson spent an undisclosed amount of research and development dollars over several years to develop the $17,000 V-Rod motorcycle. The V-Rod, introduced in 2001, had 110 horsepower, nearly double that of the standard Harley Bike. The V-Rod was the quickest and fastest production model the company had ever built, capable of reaching 60 miles an hour in 3.5 seconds and 100 mph in a little over 8 seconds. Its top speed is about 140 mph. All in all, the V-Rod was faster and handled better than the traditional bulky Harley bikes.

All other Harley models are powered by 45-degree V-twin air-cooled engines with camshafts in the block; the new V-Rod has a 1,130-cc 60-degree engine with double overhead cams and four values for each cylinder. The V-Rod has a very long 67.5-inch wheelbase, and it handles better than other Harleys because it is so much lighter. Furthermore, the V-Rod is only 26 inches off the ground, so it will accommodate a wide range of rides.[7] Harley-Davidson hoped to gain some of the younger markets with this new bike.

In 2000, a new Softail model was introduced and all Softail models were outfitted with the twin Cam 88B engine. Fuel injection was introduced for the Softails in 2001 and in 2000; Buell introduced the Buell Blast, which was a single-cylinder bike. Along with the Buell Blast, Harley-Davidson introduced a new beginner rider's course aimed at the first time Harley owner and rider. The course was offered in Harley-Davidson and Buell dealerships. The VRSCA V-Rod in 2002 was the first Harley bike to combine fuel injection, overhead cams, and liquid cooling along with new 115 horsepower.

In an attempt to gain further female support, Harley-Davidson announced the introduction of 17-year-old Jennifer Snyder, a champion dirt bike racer as the newest member of the Harley-Davidson racing team. Female racers were starting to enter this predominantly male sport and Harley-Davidson would not miss this opportunity to challenge market perceptions of a Harley-Davidson rider.

In 2003, Harley-Davidson introduced the Lightning XBS9. In 2004, the Sportsters were refitted with rubber engine mounting, a new frame and a wider rear tire. The FLHRSI Road King was introduced with low rear suspension and wide handlebars for a beach appearance. In 2005, the XL 883 Sportster 883 Low, featuring a lowered seating position aimed at aging baby boomers, was added to the Sportster line. The FLSTNI Softail Deluxe was added to the

Softail line with a new sleek appearance reminiscent of the 1939 Harley-Davidson bike. In the same year, the FLSTSC/I Softail Springer-Classic revived the late 1940s bike in appearance.

In 2006, the Dyna motorcycle line was developed with the first 6-speed transmission. The new FLHX/I Street Glide was introduced as a lower profile touring bike. Scheduled for opening in 2008 was the Harley-Davidson museum in Milwaukee, Wisconsin. In the area of international development, the first dealership was opened in mainland China. In 2008, the company introduced four new bikes aimed at two markets—aging baby boomers and the growing female market.

Corporate Governance

Board of Directors

The Board of Directors consisted of 11 members, of which only two were internal members—James L. Ziemer, President and Chief Executive Officer (CEO), and Thomas E. Bergman, the Chief Financial Officer. **Exhibit 1** highlights board members in 2008.

The Board of Directors serve three-year staggered terms. Each of the nine non-employee directors are compensated $100,000 per year. At least half of this amount is to be paid in common stock.

Since 2005, the board has authorized a stock repurchase. In 2007, 2006, and 2005, the Company repurchased 20.4 million, 19.3 million, and 21.4 million shares of its common stock at weighted-average prices of $56, $55, and $49, respectively. As of February 2008, all of the 20 million shares authorized in 2007 remained to be repurchased. Each of the prior two years authorizations were fully repurchased by the end of the next year.

Top Management

James C. Ziemer started with Harley-Davidson 38 years ago as a freight elevator operator and served as the CFO from 1991 to 2005. In 2005, upon the retirement of Harley veteran Jeffrey Bluestein, Ziemer assumed the top role of President and CEO. He commented, "Harley-Davidson is strong and well-positioned for the road ahead."[8] Ziemer further commented:

> *I believe there are three constants in our success as a company: 1. Our passion for this business, for riding, and for relating to and being one with our customers; 2. Our sense of purpose—in other words, our focus on growing demand by offering great products and unique experiences; and 3. Operational Excellence—which is the continuous, relentless drive to eliminate waste in all aspects of our operations and to run Harley-Davidson better and more efficiently with each passing day. And I believe these three things—being close to our customers, growth and Operational Excellence—hold the keys to the future.*[9]

Exhibit 2 shows the corporate officers for Harley-Davidson and its business segments—motor company leadership, Buell leadership, and financial services leadership.

Through 2006, Harley-Davidson received positive attention from the popular press in terms of rankings. In 2006, Business Week/Interbrand Annual Rankings Top 100 Global Brands placed Harley-Davidson at #45, up 1 from 2005. Fortune also placed Harley-Davidson in its 2004 list of "Most Admired Companies."[10] Previously, Forbes named Harley Davidson its "Company of the Year" for 2001. Harley-Davidson did not make Fortune's list in 2008.

In 2007, Harley-Davidson experienced its first decline in 20 years. Motorcycle revenue was down 1.27% over 2006, total revenue was down 0.69% and, perhaps most importantly, operating income suffered a 10.74% decline. Harley-Davidson, which had fought back from near demise in the 1980s was to face new rivals in the competitive market, an aging customer base, and the recession. Given the recession in 2008, what did the future hold for Harley-Davidson? These were issues management wrestled with as they planned for the future. One possible solution was to gain new, younger customers as the future as their current customers aged.

EXHIBIT 1
Board of Directors: Harley-Davidson Inc.

Barry K. Allen, *President, Allen Enterprises, LLC*
Barry has been a member of the Board since 1992. His distinguished business career has taken him from the telecommunications industry to leading a medical equipment and systems business and back again. Barry's diverse experience has been particularly valuable to the Board in the areas of marketing and organization transformation.

Richard I. Beattie, *Chairman of the Executive Committee, Simpson Thacher & Bartlett*
Dick has been a valued advisor to Harley-Davidson for nearly 20 years. His contributions evolved and grew with the company over time. In the early 1980s, he provided legal and strategic counsel to the 13 leaders who purchased Harley-Davidson from AMF, taking it back to private ownership. He also advised the team when it was time to take the company public again in 1986. Dick was elected to the Board in 1996.

Jeffrey L. Bleustein, *Chairman of the Board, Harley-Davidson, Inc.*
Jeff began his association with Harley-Davidson in 1975 when he was asked to oversee the engineering group. During his tenure as Vice President-Engineering, Harley-Davidson developed the Evolution engine and established the foundations of our current line of cruiser and touring motorcycles. Jeff has demonstrated creativity and vision across a wide range of senior leadership roles. In 1996, he was elected to the Board, and in June 1997, appointed CEO until his retirement in 2005. He remains on as Chairman of the Board.

George H. Conrades, *Executive Chairman of Akamai Technologies, Inc.*
George has served as a director since 2002 and brings with him extensive experience in e-business. Akamai Technologies is a provider of secure, outsourced e-business infrastructure services and software. He is also a partner with Polaris venture Partners, an early-stage investment company.

Judson C. Green, *President and CEO, NAVTEQ Corporation*
NAVTEQ is a leading provider of comprehensive digital map information for automotive navigation systems, mobile navigation devices and Internet-based mapping applications. Judson has served as a director since 2004.

Donald A. James, *Vice Chairman and Chief Executive Officer, Fred Deeley Imports, Inc.*
Don's wisdom and knowledge of the motorcycle industry has guided the Board since 1991. As a 31-year veteran of Harley-Davidson's exclusive distributor in Canada, he has a strong sense for our core products. Don has a particularly keen understanding of the retrial issues involved with motorcycles and related products and the competitive advantage inherent in strong, long-lasting dealer relationships.

Sara L. Levinson, *ChairMom and Chief Executive Officer, ClubMom, Inc.*
Sara joined the Board in 1996. She understands the value and power of strong brands, and her current senior leadership role in marketing and licensing, together with her previous experience at MTV, give her solid insights into the entertainment industries and younger customer segments.

George L. Miles, Jr., *President and CEO, WQED Multimedia*
George has been a director since 2002 and currently serves as president and CEO of WQED Multimedia, the public broadcaster for southwestern Pennsylvania.

James A. Norling, *Executive Vice President, Motorola, Inc.; President, Personal Communications Sector, retired*
Jim has been a Board member since 1993. His career with Motorola has included extensive senior leadership assignments in Europe, the Middle East, and Africa, and he has generously shared his international experience and understanding of technological change to benefit Harley-Davidson.

James L. Zeimer, *President and CEO, Harley Davidson, Inc.*
Jim has been with Harley-Davidson for over 38 years and served as CFO until 2005 when he assumed the role of CEO upon Jeff Bluestein's retirement. He has been a director since 2004.

Jochen Zeitz, *Chief Executive Officer and Chairman of the Board, Puma AG.*
Mr. Zeitz was elected to the Board in August 2007 when the size of the Board grew from 10 to 11 members. Mr. Zeitz will serve as a Class II director with a term expiring at the Company's 2008 annual meeting of shareholders.

SOURCE: *Harley Davidson, Inc., 2007 Form 10-K, page 99.*

EXHIBIT 2

1. Corporate Officers, Harley-Davidson, Inc.

James L. Ziemer
President and Chief Executive Officer

Thomas E. Bergmann
Executive Vice President, and Chief Financial Officer

Gail A. Lione
Vice President, General Counsel and Secretary

James M. Brostowitz
Vice President, Treasure, and Chief Accounting Officer

2. Motor Company Leadership

Joanne M. Bischmann
Vice President, Marketing

David P. Bozeman
General Manager, Powertrain Operations

James M. Brostowitz
Vice President and Treasurer

Leroy Coleman
Vice President, Advanced Operations

Rodney J. Copes
Vice President and General Manager, Powertrain Operations

William B. Dannehl
Vice President, North American Sales and Dealers Services

William G. Davidson
Vice President and Chief Styling Officer

Karl M. Eberle
Vice President and General Manager, Kansas City Operations

Robert S. Farchione
General Manager, Parts and Accessories

Fred C. Gates
General Manager, York Operations

James E. Haney
Vice President and Chief Information Officer

Michael P. Heerhold
General Manager, Tomahawk

Timothy K. Hoelter
Vice President, Government Affairs

Ronald M. Hutchinson
Vice President, New Business

Michael D. Keefe
Vice President and Director, Harley Owners Group®

Kathleen A. Lawler
Vice President, Communications

Lara L. Lee
Vice President, Enthusiast Services

Matthew S. Levatich
Vice President, Materials Management

Gail A. Lione
Vice President and General Counsel

James A. McCaslin
President and Chief Operating Officer

Jeffrey A. Merten
Managing Director, Asia Pacific and Latin America

Louis N. Netz
Vice President and Director, Styling

John A. Olin
Vice President, Controller

Steven R. Phillips
Vice President, Quality, Reliability and Technical Services

Harold A. Scott
Vice President, Human Resources

Patrick Smith
General Manager, General Merchandise

W. Kenneth Sutton, Jr.
Vice President, Engineering

Michael van der Sande
Managing Director, HD Europe

Jerry G. Wilke
Vice President, Customer Relationships and Product Planning

3. Harley-Davidson Financial Services Leadership

Lawrence G. Hund
Vice President, Operations and Chief Financial Officer

Kathryn H. Marczak
Vice President, Chief Credit and Administrative Officer

Saiyid T. Naqvi
President

4. Buell Motorcycle Company Leadership

Erik F. Buell
Chairman and Chief Technical Officer

Jon R. Flickinger
President and Chief Operating Officer

SOURCE: *Harley Davidson, Inc., 2006 Annual Report, p. 32.*

Harley Owners Group (H.O.G)

A special kind of camaraderie marked the Harley Owners Group rallies and other motorcycle events. At events and rallies around the world, members of the H.O.G. came together for fun, adventure, and a love of their machines and the open road. As the largest motorcycle club in the world, H.O.G. offered customers organized opportunities to ride their famed bikes. H.O.G. rallies visibly promote the Harley-Davidson experience to potential new customers and strengthened the relationships among members, dealers, and Harley-Davidson employees.

William G. Davidson, grandson of the co-founder, biker to the core, known to all as Willie G., says, "There's a lot of beaners, but they're out on the motorcycles, which is a beautiful thing." He noted that he recently co-led a national rally of Canadian HOG groups with Harley's Chairman Jeff Bleustein.[11]

In 1995, the Buell Riders Adventure Group (BRAG) was created to bring Buell motorcycle enthusiasts together and to share their on-road experiences. Harley-Davidson plans to grow both organizations with new members and chapters in the years to come.

Exhibit 3 provides a profile of H.O.G and BRAG clubs. In 2007, H.O.G. membership grew to over 1,000,000 strong, making it the largest factory-sponsored motorcycle club in the world. The newer BRAG club for Buell riders numbered 11,000 members.

EXHIBIT 3
2007 Profile of the HOG and BRAG: Harley-Davidson Inc.

HOG Sponsored Events: In 2007, H.O.G. continued to sponsor motorcycling events on local, regional, national, and international levels. The sixteenth annual international H.O.G. Rally drew tens of thousands of members.

HOG Membership: Any Harley-Davidson motorcycle could become a member of H.O.G. In fact, their first year of membership was included with the purchase of a new Harley-Davidson motorcycle. The number of H.O.G. members had grown rapidly since the motorcycle organization began in 1983 with 33,000 members. Now, the largest factory sponsored motorcycle organization in the world, there were over 1 million H.O.G. members in 130 countries worldwide. Sponsorship of H.O.G. chapters by Harley-Davidson dealers grew from 49 chapters in 1985 to over 1,400 chapters in 2007.

A Snapshot of H.O.G.	
Created in	1983
Worldwide members	>1,000,000
Worldwide dealer-sponsored chapters	1,400
Countries with members	115
A Snapshot of BRAG (Buell Riders Adventure Group)	
Created in	1995
Worldwide members	11,000
Number of clubs	55

SOURCE: *Harley-Davidson, Inc, http://www.harley-davidson.com.*

The Harley-Davidson Museum

In June 2006, Harley-Davidson began construction of a 130,000 square foot museum. The museum houses a collection of motorcycles and historical mementos from the company's 105-year history. It was anticipated there will be over 350,000 visitors each year to the Milwaukee museum with an anticipated opening in summer 2008.

"With over one hundred years and millions of motorcycles behind us, Harley-Davidson has a rich history, and exciting present, and a vibrant future. In the years to come, the Harley-Davidson Museum will be a centerpiece of the Harley-Davidson experience." said CEO Ziemer.[12]

Domestic and Foreign Distribution[13]

United States

Domestically, Harley-Davidson sold its motorcycles and related products at wholesale to a network of approximately 684 independently-owned full-service Harley-Davidson dealerships. Included in this figure were 307 combined Harley-Davidson and Buell dealerships. In 2007, in partial response to a dismissed lawsuit alleging improper allocation of motorcycles, Harley-Davidson implemented a new U.S. motorcycle distribution system to better align demand with supply of bikes.

With respect to sales of new motorcycles, approximately 80% of the U.S. dealerships sold the Harley-Davidson motorcycles exclusively. Independent dealers also sold a smaller portion of parts and accessories, general merchandise, and licensed products through "non-traditional" retail outlets. The "non-traditional" outlets, which serve as extensions of the main dealerships, consist of Secondary Retail Locations (SRLs), Alternate Retail Outlets (AROs), and Seasonal Retail Outlets (SROs). Secondary retail locations are satellites of the main dealership and were developed to meet the service needs of the company's riding customers. They also provided parts and accessories, general merchandise, and licensed products and were authorized to sell and service new motorcycles. Alternate retail outlets, located primarily in high-traffic locations such as malls, airports, or popular vacation destinations, focus on selling general merchandise and licensed products. Seasonal retail outlets, located in similar high-traffic areas, operate on a seasonal basis. There were approximately 104 SRLs, 68 AROs, and 12 SROs in the United States.

Foreign Operations

Revenue from the sale of motorcycles and related products to independent dealers and distributors located outside of the United States was approximately $1.52 billion, $1.18 billion, and $1.04 billion, or approximately 27%, 20%, and 19% of net revenue of the Motorcycles segment during 2007, 2006, and 2005, respectively.

Europe/Middle East/Africa

At the end of 2007, there were 370 independent Harley-Davidson dealerships serving 32 European country markets. This included 323 combined Harley-Davidson and Buell dealerships. Buell was further represented by four dealerships that did not sell Harley-Davidson motorcycles. Harley-Davidson planned to open a new sales office in South Africa in 2008.

Asia-Pacific

In the Asia/Pacific region, Harley-Davidson sold motorcycles and related products at wholesale to independent dealers and distributors. In Japan, sales, marketing, and distribution of product are managed from its subsidiary in Tokyo, which sold motorcycles and related products through 130 independent Harley-Davidson dealers. Fifty-seven of these dealers sell both Harleys and Buells. Three dealerships sold only Buell Bikes.

In Australia and New Zealand, the distribution of Harley-Davidson products was managed by independent distributors that purchased directly from the Harley-Davidson's U.S. operation. In 2007, the Harley-Davidson's subsidiary in Sydney, Australia managed the sales, marketing, and distribution in that region. The Australia/New Zealand market was served at retail by a network of 49 independent Harley-Davidson dealerships, including 32 that sold both Harley-Davidson and Buell products.

Latin America

In Latin America, Harley-Davidson sold motorcycles and related products at wholesale to independent dealers. Harley-Davidson supplied all products sold in the Latin America region directly to independent dealers from its U.S. operations, with the exception of certain motorcycles sold in Brazil which are assembled and distributed by the Company's subsidiary in Manaus, Brazil.

In Latin America, 12 countries were served by 31 independent dealers. Brazil was the company's largest market in Latin America and was served by 10 dealers. Mexico, the region's second largest market had 11 dealers. In the remaining Latin American countries, there were 10 dealers.

Canada

In Canada, Harley-Davidson sold its motorcycles and related products at wholesale to a single independent distributor, Deeley Harley-Davidson Canada/Fred Deeley Imports Ltd. In Canada, there were 75 independent Harley-Davidson dealerships. In Canada, 45 of the 74 dealerships sell both Harley-Davidson and Buell products.

Business Segments

Harley-Davidson operates in two principal business segments: Motorcycles and Related Products (Motorcycles) and Financial Services. **Exhibit 4** provides financial information on the company's two business segments.

Motorcycles and Related Products Segment

The primary business of the Motorcycles segment is to design, manufacture, and sell premium motorcycles for the heavyweight market. They are best known for Harley-Davidson motorcycle products, but also offer a line of motorcycles and related products under the Buell brand name. Sales from the company's Motorcycle segment generated 93.2%, 93.8%, and 94.2% of the total sales during 2007, 2006, and 2005, respectively; with the remainder coming from the Financial Services segment.

The majority of the Harley-Davidson branded motorcycle products emphasizes traditional styling, design simplicity, durability, ease of service, and evolutionary change. Harley's

EXHIBIT 4
Information by Business Segments: Harley-Davidson Inc. (Dollar amounts in thousands)

A. Revenues and Income from Operations

Year ending December 31	2007	2006	2005
Net sales and Financial Services income:			
Motorcycles and Related Products net sales	$5,726,848	$5,800,686	$5,342,214
Financial Services income	416,196	384,891	331,618
	$6,143,044	$6,185,577	$5,673,832
Income from operations:			
Motorcycles and Related Products	$1,230,643	$1,408,990	$1,299,865
Financial Services	212,169	210,724	191,620
General corporate expenses	(17,251)	(22,561)	(21,474)
Operating Income	$1,425,561	$1,597,153	$1,470,011

B. Assets, Depreciation, and Capital Expenditures
(Dollar amount in thousands)

	Motorcycles and Related Products	Financial Services	Corporate	Consolidated
2007				
Identifiable Assets	$1,804,202	$3,447,075	$405,329	$5,656,606
Depreciation and Amortization	197,655	6,517	-	204,172
Net Capital Expenditures	232,139	9,974	-	242,113
2006				
Identifiable Assets	$1,683,724	$2,951,896	$896,530	$5,532,150
Depreciation & Amortization	205,954	7,815	-	213,769
Net Capital Expenditures	209,055	10,547	-	219,602
2005				
Identifiable Assets	$1,845,802	$2,363,235	$1,046,172	$5,255,209
Depreciation and Amortization	198,833	6,872	-	205,705
Net Capital Expenditures	188,078	10,311	-	198,389

SOURCE: *Harley Davidson, Inc., 2007 Form 10-K, p. 95.*

appeal straddles class boundaries, stirring the hearts of grease monkeys and corporate titans alike. Malcolm Forbes, the late owner of Forbes magazine, was pivotal in introducing Harleys to the business elite in the early 1980s.[14]

Based on data from the Motorcycle Industry Council owner survey, nearly 1 out of every 10 motorcycle owners is female[15] The average U.S. Harley-Davidson motorcycle purchaser is a married male in his late-forties, with a household income of approximately $81,300, who purchases a motorcycle for recreational purposes rather than to provide transportation and is an experienced motorcycle rider. Over two-thirds of the firm's U.S. sales of Harley-Davidson motorcycles are to buyers with at least one year of education beyond high school, and 31% of the buyers have college degrees. (See **Exhibit 5**.)

In an effort to grow and recognize the importance of female riders to Harley-Davidson, the company partnered with *Jane* magazine in 2005 in a contest called the Spirit of Freedom Contest to recognize women who overcome fears and other obstacles to become Harley riders. The grand prize winner was to receive a new Sportster 883. "The adrenaline rush of riding a motorcycle out on the open is like no other experience. Through this contest, we are saluting women

EXHIBIT 5
Purchaser Demographic Profile: Harley-Davidson Inc.

	2006	2005	2004	2003	1983
Gender					
Male	88%	89%	89%	89%	*98%*
Female	12%	12%	11%	11%	*2%*
Median Age					
Years	47.1	46.5	46.1	45.2	*34.1*
Median Household Income ($000)	82.1	81.6	80.8	83.3	*38.3*
2006 Purchasers					
49%	Owned Harley-Davidson motorcycle previously				
37%	Coming off of competitive motorcycle				
14%	New to motorcycling or haven't owned a motorcycle for at least 5 years				

SOURCE: *Harley Davidson Fact Book, posted November 5, 2007, at http://investor.harley-davidson.com/downloads/factsheet.pdf.*

who embody that spirit of adventure through small gestures, inner strength, and everyday selfless acts" commented Kathleen Lawler, Vice President of Communications, Harley-Davidson.[16]

Buell motorcycle products emphasize innovative design, responsive handling, and overall performance. The Buell motorcycle product line has traditionally consisted of heavyweight performance models, powered by the 1200cc V-Twin engine. However, in 2000, they introduced the Buell Blast, a new vehicle designed specifically to attract new customers into the sport of motorcycling. This vehicle was considerably smaller, lighter, and less expensive than the traditional Buell heavyweight models and is powered by a 492-cc single-cylinder engine. The Buell line has continued to grow since the introduction of the lower-priced Buell Blast.

The average U.S. purchaser of the Buell heavyweight motorcycle is a male at the median age of 39 with a median household income of approximately $61,600. Internal documents indicate that half of Buell Blast purchasers have never owned a motorcycle before, and in excess of 95% of them had never owned a Buell motorcycle before. The median age of Blast purchasers is 38, with over one-half of them being female.

The heavyweight motorcycle market is comprised of four segments: standard, which emphasizes simplicity and cost; performance, which emphasizes handling and acceleration; touring, which emphasizes comfort and amenities for long-distance travel; and custom, which emphasizes styling and individual owner customization.

In 2008, Harley-Davidson manufactured and sold 30 models of Harley-Davidson touring and custom heavyweight motorcycles, with domestic manufacturer's suggested retail prices ranging from approximately $6,695 to $20,645. There were eight Buell bikes ranging from $4,695 to $11,995. (See **Exhibit 6**.) The touring segment of the heavyweight market was pioneered by Harley-Davidson and includes motorcycles equipped for long-distance touring with fairings, windshields, saddlebags, and Tour Pak luggage carriers. The custom segment of the market includes motorcycles featuring the distinctive styling associated with classic Harley-Davidson motorcycles. These motorcycles are highly customized through the use of trim and accessories.

Harley-Davidson's traditional heavyweight motorcycles are based on variations of five basic chassis designs and are powered by one of four air-cooled, twin cylinder engines with a 45-degree "V" configuration, which have displacements of 883cc, 1200cc, 1450cc, and 1550cc. The V-Rod has its own unique chassis design and is equipped with the new Revolution powertrain, a new liquid-cooled, twin-cylinder, 1130cc engine, with a 60-degree "V" configuration.

EXHIBIT 6
2008 Motorcycles Product Line: Harley-Davidson Inc.

Motorcycle	MSRP Base Price ($)
1. BUELL[1]	
Buell® 1125R	11,995
XB12X Ulyssest®	11,495
XB12S/XB12Scg Lightning®	10,495
XB12STT Lightning® Long	10,495
XB12STT Lightning®	10,295
XB12R Firebolt®	9,995
XB9SX Lightning® CityX	8,895
XB9SX Blast	4,695
2. HARLEY-DAVIDSON SPORTSTER	
XL1200C Sportster® Custom	9,895
XL 1200L Sportster® Low	9,695
XL1200N Sportster® Nightster™	9,695
XL1200R Sportster® Roadster	8,895
XL883C Sportster® Custom	7,945
XL883L Sportster®Low	7,145
XL883 Sportster®	6,695
3. DYNA	
FXDWG Dyna® Wide Glide 105th Anniversary Edition	17,620
FXDF Dyna® Low Rider®	14,995
FXDF Dyna® Fat Bob™	14,795
FXDB Dyna® Street Bob®	13,795
FXDC Dyna® Super Glide® Custom	12,995
FXD Dyna® Super Glide®	11,995
4. SOFTAIL	
FXCWC Softail Rocker™ C	19,840
FLSTC Heritage Softail® Classic	17,945
FLSTN Softail® Deluxe	17,445
FXCW Softail Rocker™	17,295
FLSTF Fat Boy®	17,195
FXSTC Softail® Custom	16,895
FXSTb Night Train®	15,895
5. VRSC™ Family (V-Rod)	
VRSCAW V-Rod®	16,995
VRSCDX Night Rod® Special	16,695
VRSCD Night Rod®	14,995
6. TOURING	
FLHTCU Ultra Classic® Electra Glide®	20,695
FLHTC Electra Glide® Classic	18,695
FLHX Street Glide	18,675
FLTR Road Glide®	18,145
FLHR Road King®	17,945
FLHT Electra Glide® Standard	16,545

[1]Buell Motorcycle Company partnered with Harley-Davidson in 1993 and was purchased by Harley-Davidson in 1998.

SOURCE: *http://www.harley-davidson.com/wcm/Content/Pages/2008_Motorcycles/2008_Motorcycles.jsp?locale=en_US& cwpws/dwp/cont-without-flash=true&swfdwp=&dwp_dealerid=&dwp_pg=&cwpws/dwp/dwp-dealer-id=.*

Although there are some accessory differences between the top-of-the line touring motorcycles and those of its competitors, suggested retail prices are generally comparable. The prices for the high-end of the Harley-Davidson custom product line range from being competitive to 50% more than its competitors' custom motorcycles. The custom portion of the Harley-Davidson product line represents their highest unit volumes and continues to command a premium price because of the features, styling, and high resale value associated with Harley-Davidson custom products. The smallest displacement custom motorcycle (the 883cc Sportster) is directly price competitive with comparable motorcycles available in the market. The surveys of retail purchasers indicate that, historically, over three-quarters of the purchasers of its Sportster model either have previously owned competitive-brand motorcycles or are completely new to the sport of motorcycling or have not participated in the sport for at least five years. Since 1988, research has consistently shown purchasers of Harley-Davidson motorcycles have a repurchase intent in excess of 90%, and management expects to see sales of its 883cc Sportster model partially translated into sales of its higher-priced products in the normal two-to-three-year ownership cycle.

Worldwide Parts and Accessories net sales comprised 15.2%, 14.9%, and 15.4% of net sales in the motorcycles segment in 2007, 2006, and 2005, respectively. Worldwide net sales of general merchandise, which includes MotorClothes apparel and collectibles, comprised 5.3%, 4.8%, and 4.6% of net sales in the Motorcycles segment in 2007, 2006, and 2005, respectively.

Management also provides a variety of services to its dealers and retail customers, including service training schools, customized dealer software packages, delivery of its motorcycles, an owners club membership, a motorcycle rental program, and a rider training program that is available in the United States through a limited number of authorized dealers.

President and CEO's Comments[17]

James Ziemer has served as CEO since April 2005. Thomas E. Bergman, 41, succeeded him as Chief Financial Officer. Ziemer "has the information of where we're going, but he's also rooted in where we've been" commented Kirk Topel, co-owner of Hal's Harley-Davidson dealership in New Berlin, Wisconsin.

President Ziemer said in the press release announcing 2007 financial results,

> *Harley-Davidson managed through a weak U.S. economy during 2007. We reduced our wholesale motorcycle shipment plan for the fourth quarter, fulfilling our commitment to our dealers to ship fewer Harley-Davidson motorcycles than we expected our dealers worldwide to sell at retail during 2007. While these are challenging times in the U.S., our international dealer network delivered double digit retail sales growth in 2007.*
>
> *For 2008, the Company once again plans to ship fewer Harley-Davidson motorcycles than it expects its worldwide dealer network to sell. The Company also expects moderate revenue growth, lower operating margin, and diluted earnings per share growth rate of 4 to 7 percent compared to 2007. For the first quarter, it expects to ship between 68,000 and 72,000 Harley-Davidson motorcycles, which compares to 67,761 units in the first quarter of 2007.*

Commenting on the long-term sustainability and the economy, Ziemer continued,

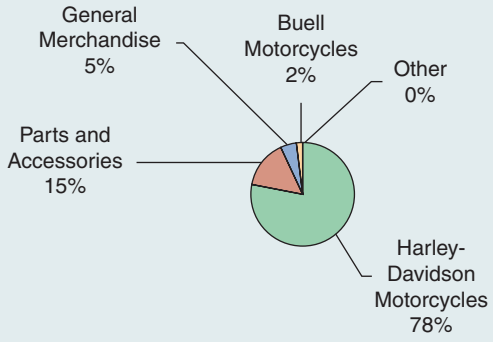
> *Looking ahead, we will continue to manage the Company to generate long-term sustainable shareholder value while protecting the brand. We expect the U.S. economy to continue to be very challenging in 2008, and we will closely monitor the retail environment and regularly assess our wholesale shipments throughout the year.*

Exhibits 7 and **8** present data on divisional revenues, worldwide motorcycle shipments, income, and registrations, both worldwide and U.S, and Europe for 2007.

EXHIBIT 7
Selected United States and World Financial and Sales Information: Harley-Davidson Inc.

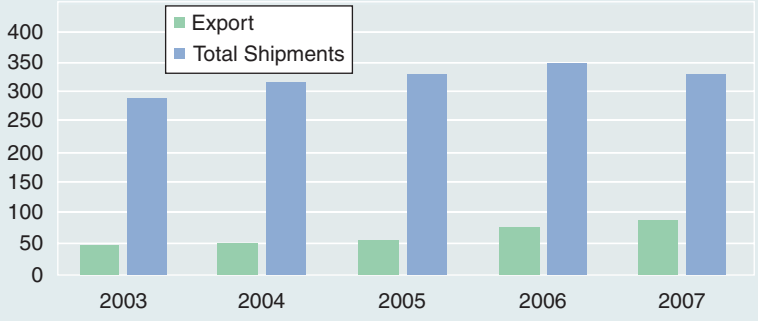
A. Motor Company Revenue, 2007
(Dollar amounts in millions)

Harley-Davidson Motorcycles	$4,446.8
Parts and Accessories	868.3
General Merchandise	305.4
Buell Motorcycles	100.5
Other	6.0
Total	$5,727.0



B. Worldwide Motorcycle Shipments
(Units in thousands)

	2003	2004	2005	2006	2007
Exports	47.7	50.8	52.5	75.8	89.1
Total Motorcycle Shipments	291.1	317.3	329.0	349.2	330.6
Export Percentage	16.4%	16.0%	16.0%	21.7%	26.9%



(Continued)

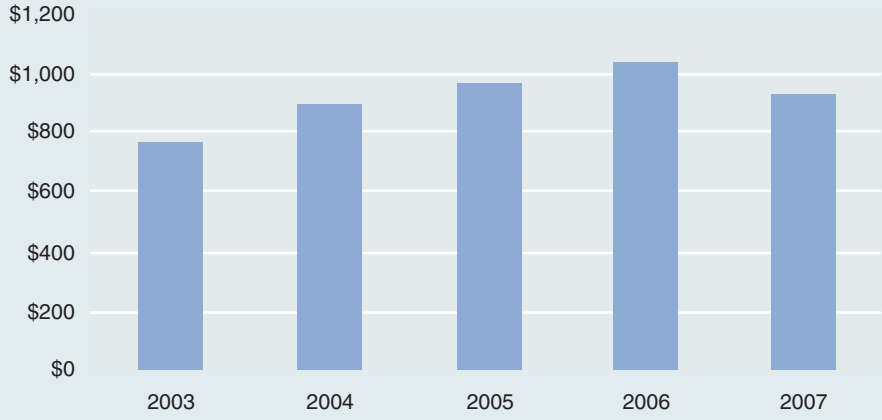
EXHIBIT 7
(Continued)

C. Worldwide Parts & Accessories and General Merchandise Revenue
(Dollar amounts in millions)

	2003	2004	2005	2006	2007
General Merchandise	211.4	223.7	247.9	277.5	305.4
Parts and Accessories	712.8	781.6	815.7	862.3	868.3

D. Net Income from Continuing Operations
(Dollar amounts in millions)

2003	2004	2005	2006	2007
$761	$890	$960	$1,043	$933



SOURCE: *Harley-Davidson, Inc., 2007 and 2005 Annual Report and 10-K.*

EXHIBIT 8

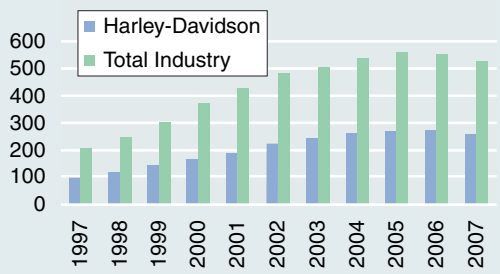
World Registrations: Harley-Davidson Inc.

A. North American 651 + cc Motorcycle Registrations

(Units in thousands)

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total Industry	206.1	246.2	297.9	365.4	422.8	475.0	495.4	530.8	553.5	543.0	516.1
Harley-Davidson	99.3	116.1	142.0	163.1	185.6	220.1	238.2	255.8	264.7	267.9	251.4
Harley-Davidson Market Share	48.2%	47.2%	47.7%	44.6%	43.9%	46.3%	48.1%	48.2%	47.8%	49.3%	48.2%

1997–2007 North American 651 + cc Motorcycle Registrations



B. European 651 + cc Motorcycle Registrations

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Total Industry	250.3	270.2	306.7	293.4	293.6	331.8	323.1	336.2	332.8	376.8	403.0
Harley-Davidson	15.1	15.7	17.8	19.9	19.6	23.5	26.3	25.9	29.7	34.3	38.7
Harley-Davidson Market Share	6.0%	5.8%	5.8%	6.8%	6.7%	7.1%	8.2%	7.7%	8.9%	9.1%	9.6%

1997–2007 European 651 + cc Motorcycle Registrations

SOURCE: *Harley-Davidson, Inc., 2007 Annual Report, p. 40.*

New Millennium Bikes: The Buell and the V-Rod

Harley's new V-Rod was introduced in the Los Angeles Convention Center on July 12, 2001. More than 4,000 packed into the center for the company's long-awaited announcement. The cavernous room went black. The engines roared in the darkness. Spotlights clicked on and followed two glinting new hot-rods as they roared onto center stage.[18]

Harley-Davidson deviated from its traditional approach to styling, with the introduction of the V-Rod motorcycle. The new, liquid cooled V-Rod, inspired by Harley-Davidson's drag racing heritage, combines the characteristics of a performance motorcycle with the styling of a custom.[19] Liquid cooling allows riders to rev a little higher and hotter in each gear, boosting acceleration. It doesn't sound like a big deal, but it was a giant step for a company so stubbornly conservative that it has made only air-cooled engines for 100 years; its designers just couldn't bear the idea of placing a radiator on the front of the bike.[20]

The V-Rod is Milwaukee-based Harley-Davison Inc.'s first truly new motorcycle in more than 50 years. A sleek machine in the making for more than six years, the V-Rod is designed more for speed and handling, unlike the company's immensely popular touring bikes.[21]

As it ramped up production, premiums on many models disappeared. Chief Executive Officer James L. Ziemer says Harley wants to "narrow the gap" between supply and demand in order to curb the long-standing—but fast-diminishing—practice of selling bikes at a premium.[22] The V-Rod's $17,000 price tag has also failed to win younger buyers.[23] To that end, Harley has poured money into developing new, youth-oriented models. The V-Rod—a low-slung, high-powered number known formally as a sport performance vehicle and colloquially as a crotch rocket—was meant for hard-charging youths. Harley has also tried to go young with the Buell Firebolt ($10,000), its answer to Japanese sport bikes, and the Buell Blast ($4,400), a starter motorcycle.

At the Detroit Harley-Davidson/Buell dealership in Center Line, owner Jim Loduca commented: "This is the first time in 10 years that I've actually had product on the floor available, but our sales are also up by 14 percent this year. The company has watched this demand curve very carefully. They are simply riding the wave. They know full well that it would be catastrophic to saturate the market." He is also encouraged by Harley's biggest product departure in recent decades—the V-Rod muscle bike.[24]

Clay Wilwert, whose family has owned a dealership in Dubuque since 1959, "But guess what, as they rode it, they loved it." They said, "Hey, this is really cool that it doesn't shake my hands asleep."[25]

Some Harley traditionalists say the V-Rod, styled to compete with super-fast European bikes, strays too far from the company's all-American roots, which tend to favor heavier cruising machines.[26]

Licensing[27]

Harley-Davidson endeavored to create an awareness of the "Harley-Davidson" brand among the non-riding public and provides a wide range of product for enthusiasts by licensing the name "Harley-Davidson" and numerous related trademarks. Harley-Davidson had licensed the production and sale of a broad range of consumer items, including T-shirts, jewelry, small leather goods, toys, and numerous other products (licensed products). Although the majority of licensing activity occurs in the United States, Harley-Davidson continues to expand these activities in international markets. Royalty revenues from licensing, included in Motorcycles segment net revenue, were approximately $46 million, $45.5 million, and $43 million in 2007, 2006, and 2005, respectively.

Marketing and Distribution[28]

Marketing efforts are divided among dealer promotions, customer events, magazine and direct mail advertising, public relations, cooperative programs with Harley-Davidson/Buell dealers, and national television advertising. Harley-Davidson also sponsors racing activities and special promotional events and participates in all major motorcycle consumer shows and rallies.

E-Commerce[29]

Since 2001, Harley-Davidson utilized a highly interactive Web site at www.harley-davidson.com. Their model is unique in the industry in that, while the online catalog is viewed from the Harley-Davidson Web site, orders are actually distributed to the participating authorized Harley-Davidson dealer that the customer selects. In turn, those dealers fill the order and handle any after-sale services that the customer may require. In addition to purchasing, customers actively browse the site, create and share product wish lists, and utilize the dealer locator.

Harley-Davidson Customer Base

Harley-Davidson's customers are not what some people might expect. They see the rough and tumble riders and do not expect that a good proportion of Harley-Davidson riders are white-collar workers and executives taking the weekend relaxation on their bike. Selected quotes from customers follow:

- "It's about an image—freedom of the road, hop on your bike and go, independent living, the loosing of the chains," said Dave Sarnowski, a teacher and Harley rider from La Farge, Wisconsin.[30]
- "The Harley people I know go to church, have jobs, shop at the mall, just like everyone else," says Angie Robison, 68, of Daytona Beach, who helps her husband, Joe, run a motorcycle repair shop and Harley memorabilia/accessories store. "I can wear my silks over here and my leathers over there, and I'm still the same person."[31]
- "I worked at a computer all day for the city, and for me it's pure relaxation. I wear the leathers because they're protective."[32]
- "I love the feeling of being out on that bike on the roads—especially in the mountains. You just can't beat it, the feeling you get," says Rob Barnett, Harley-Davidson owner.
- "In general, the motorcycle industry has increased for 12 years straight, and we're expecting another increase—especially in Harley-Davidson sales—this year," says Don Brown, motorcycle analyst with DJB Associates.[33]
- "A Harley is a rolling sculpture. A piece of artwork," commented Matt Chase, sales manager of N.F. Sheldon, Harley store. "You work all week, then on the weekends you put on leathers and everyone's equal . . . all the same, brothers and sisters."[34]

Recession Resistance?

Ziemer recognized that 2008 would be a challenging year for Harley-Davidson given the pending recession. How will this affect Harley-Davidson? Harley has seen tremendous sales and stock price growth since 1986 until a slowdown in 2007. Some analysts question how Harley-Davidson will be hit in a deep recession. "For years, Harley-Davidson and the analysts that covered the company have reported that the business is recession-resistant. Given the recent changes in the economic and political landscape, this assertion is being put to the

EXHIBIT 9
Motorcycle Unit Shipments and Net Sales: Harley-Davidson Inc.

	2007	2006	Increase (Decrease)	Percentage Change
Motorcycle Unit Shipments				
Touring motorcycle units	114,076	123,444	(9,368)	(11.6%)
Custom motorcycle units	144,507	161,195	(16,688)	(10.4%)
Sportster motorcycle units	72,036	64,557	7,479	11.6%
Harley-Davidson® motorcycle units	330,619	349,196	(18,577)	(5.3%)
Buell® motorcycle units	11,513	12,460	(947)	(7.6%)
Total motorcycle units	342,132	361,656	$(19,524)	(5.7%)
Net Sales ($ thousands)				
Harley-Davidson motorcycles	$4,446.6	$4,553.6	(107.0)	(2.3%)
Buell motorcycles	100.5	102.2	(1.7)	(1.7%)
Total motorcycles	$4,547.1	$4,655.8	(108.7)	(2.3%)
Parts and Accessories	$868.3	$862.3	6.0	0.7%
General Merchandise	305.4	277.5	27.9	10.1%
Other	6.0	5.1	0.9	17.7%
Total Motorcycles and Related Parts	$5,726.8	$5,800.7	$(73.9)	(1.3%)

SOURCE: *Harley-Davidson 2007 10-K, page 34.*

test, and from what we can tell, is ringing true. According the CEO Jim Ziemer, "motorcycles, the critics say, are easily deferred purchases. We always said we feel we are recession-resistant, not recession-proof."[35] (See **Exhibit 9**).

Competition[36]

The heavyweight (651+cc) motorcycle market is highly competitive. Major competitors are based outside the United States and generally have more financial and marketing resources. They also have larger worldwide sales volumes and are more diversified. In addition to these larger, established competitors, a growing segment of competition has emerged in the United States. The new U.S. competitors generally offer heavyweight motorcycles with traditional styling that compete directly with many of the Harley-Davidson's products. These competitors currently have production and sales volumes that are lower than the Harley-Davidson's and did not hold a significant market share. (See **Exhibits 10, 11, and 12**.)

Competition in the heavyweight motorcycle market is based upon a number of factors, including price, quality, reliability, styling, product features, customer preference, and warranties. Harley-Davidson emphasizes quality, reliability, and styling in its products and offers a one-year warranty for its motorcycles. Management regards its support of the motorcycling lifestyle in the form of events, rides, rallies, H.O.G., and its financing through HDFS, as a competitive advantage. In general, resale prices for used Harley-Davidson motorcycles, as a percentage of prices when new, are significantly higher than resale prices for used motorcycles of competitors.

Domestically, Harley-Davidson competes most heavily in the touring and custom segments of the heavyweight motorcycle market, which together accounted for 80%, 79%, and 80% of total heavyweight retail unit sales in the United States during 2007, 2006, and 2005, respectively. The custom and touring motorcycles are generally the most expensive vehicles in the market and the most profitable. During 2007, the heavyweight segment including standard, performance, touring, and custom motorcycles, represented approximately 54% of the total U.S. motorcycle market in terms of new units registered.

EXHIBIT 10

651+cc Motorcycle Market Regional Comparison by Segment: Harley Davidson Inc.

	2006	2005	2004	2003	2002
United States					
Custom	47.4	50.9	52.1	61.8	60.3
Touring	35.4	32.8	31.1	20.4	20.2
Performance	15.1	14.0	13.6	15.1	17.3
Standard	2.1	2.3	3.2	2.7	2.2
Total	100.1	100.0	100.0	100.0	100.0
	2006	**2005**	**2004**	**2003**	**2002**
Europe					
Custom	13.4	13.0	13.8	14.3	13.8
Touring	26.0	25.8	27.9	4.7	4.8
Performance	41.4	40.9	39.8	57.8	61.2
Standard	19.2	20.3	18.5	23.2	20.2
Total	100.1	100.0	100.0	100.0	100.0
	2006	**2005**	**2004**	**2003**	**2002**
Asia/Pacific					
Custom	30.0	30.3	29.6	32.7	26.2
Touring	9.3	9.2	9.1	9.8	8.7
Performance	47.7	47.8	54.0	53.3	60.0
Standard	13.3	12.8	7.3	4.2	5.1
Total	100.0	101.1	100.0	100.0	100.0

Notes:
Custom: Characterized by "American Styling." These bikes are often personalized with accessories.
Touring: Designed for long trips with an emphasis on comfort, cargo capacity, and reliability. These bikes often have features such as two-way radio for communication with a passenger, stereos, and cruise control.
Performance: Characterized by quick acceleration, top speed, and handling. These bikes are often referred to as sports bikes.
Standard: A basic, no frills motorcycle with an emphasis on low price. The standard percentage may also include the "adventure touring" niche.

SOURCE: *Harley Davidson Fact Book, posted November 5, 2007 at http://investor.harley-davidson.com/registrations/registrations_regional.cfm.*

EXHIBIT 11

Market Share of U.S. Heavyweight Motorcycles 1 (Engine Displacement of 651+cc)[1]

	2007	2006	2005	2004	2003	2002
New U.S. Registrations (thousands of units):						
Total market new registrations	516.2	543.0	517.6	494.0	461.2	442.3
Harley-Davidson new registrations	251.4	267.9	252.9	244.5	228.4	209.3
Buell new registrations	3.7	3.8	3.6	3.6	3.5	2.9
Total Company new registrations	255.1	271.7	256.5	248.1	231.9	212.2
Percentage Market Share						
Harley-Davidson motorcycles	48.7%	49.3%	48.9%	49.5%	49.5%	47.5%
Buell motorcycles	0.7%	0.7%	0.7%	0.7%	0.8%	0.7%
Total Company	49.4%	50.0%	49.6%	50.2%	50.3%	48.2%
Honda	14.2%	15.1%	16.6%	18.7%	18.4%	19.8%
Suzuki	12.5%	12.9%	12.4%	10.2%	9.8%	9.6%
Yamaha	9.2%	8.6%	8.9%	8.7%	8.5%	8.9%
Kawasaki	7.2%	6.8%	6.5%	6.4%	6.7%	6.9%
Other	7.5%	6.0%	6.0%	5.8%	6.3%	6.6%
Total	100.0%	99.4%	100.0%	100.0%	100.0%	100.0%

Note: [1]Motorcycle registration and market share information has been derived from data published by the Motorcycle Industry Council (MIC).

SOURCE: *Harley-Davidson, Inc., Form 10-K, 2007, page 9 and Form 10-K, 2005, page 9.*

EXHIBIT 12
Motorcycle Industry Registration Statistics (Units): Harley-Davidson Inc.

	2003	2000	1997	1994	1991
U.S. and Canada					
651+cc volume	495,436	366,247	205,407	150,419	100,705
H-D volume	238,243	163,984	99,298	69,529	48,260
Buell volume	3,719	4,306	1,912	194	n/a
HOG total volume	241,962	168,290	101,210	69,723	48,260
HOG market share	**48.8%**	**45.9%**	**49.3%**	**46.4%**	**47.9%**
Europe					
651+cc volume	323,083	338,921	282,378	201,904	194,700
H-D volume	26,299	23,230	17,190	14,393	10,996
Buell volume	3,106	2,045	785	n/a	n/a
HOG total volume	29,405	25,275	17,975	14,393	10,996
HOG market share	**9.1%**	**7.5%**	**6.4%**	**7.1%**	**5.6%**
Japan and Australia					
651+cc volume	58,941	62,667	58,880	39,077	26,995
H-D volume	15,195	12,213	9,686	7,588	5,261
Buell volume	989	658	426	n/a	n/a
HOG total volume	16,184	12,871	10,112	7,588	5,261
HOG market share	**27.5%**	**20.5%**	**17.2%**	**19.4%**	**19.5%**
Total for Markets Listed					
651+cc volume	877,460	767,835	546,665	391,400	322,400
H-D volume	279,737	199,427	126,174	91,510	64,517
Buell volume	7,814	7,009	3,123	194	n/a
HOG total volume	287,551	206,436	129,297	91,704	64,517
HOG market share	**32.8%**	**26.9%**	**23.7%**	**23.4%**	**20.0%**

Notes:
1. HOG is the ticker for Harley-Davidson. These are actual registrations of motorcycles. The Harley-Davidson, Inc. registrations are typically lower than actual sales due to timing differences.
2. Data provided by R. L. Polk (1994), Giral S. A., Australian Bureau of Statistics and H-D Japan. The most recent date available is for 2003.

SOURCE: *Harley Davidson Fact Book, posted November 5, 2007, at http://investor.harley-davidson.com/downloads/factsheet.pdf.*

For the last 20 years, Harley-Davidson has led the industry in domestic (United States) unit sales of heavyweight motorcycles. Its market share in the heavyweight market was 48.7% in 2007 compared to 49.3% in 2006. The next largest competitor in the domestic market had only a 14.2% market share.

Rider Training and Safety

"Increasingly, the motorcycle riders who are getting killed are in their 40s, 50s, and 60s," says Susan Ferguson, vice president for research at the Insurance Institute for Highway Safety, which did the study.[37] Riders over 40 accounted for 40% of all fatalities in 2000, up from 14% in 1990. Part of the reason for the dramatic increase in older biker's deaths is the growing number of men and women over 40 buying motorcycles, IIHS says.

In 2000, Harley-Davidson launched an instruction program called Rider's Edge, run through dealers. Rookies pay $225 or so for a 25-hour class. This training program can be credited with bringing in more first-time riders as Harley customers. Forty-five percent are women,

86% buy something, and 25% buy a Harley-Davidson or a Buell within three months. "Going into a Harley dealership can be intimidating," says Lara Lee, who runs the program. "We give them a home base and get them riding."[38]

In March 2008, Harley-Davidson announced the company was moving the Rider's Edge program into California. There was hope the program would encourage more motorcycle sales. Julie Chichlowski, the director of Rider Services stated, "One distinct advantage of the Rider's Edge New Rider Course is that feeling of being part of something bigger. Rider's Edge teaches the skills necessary to ride a motorcycle but in an environment that is pure Harley-Davidson.[39]

Motorcycle Manufacturing[40]

Harley-Davidson designed its manufacturing process to increase capacity, improve product quality, reduce costs, and increase flexibility to respond to market changes. Harley-Davidson incorporated manufacturing techniques focused on the continuous improvement of its operations designed to control costs and maintain quality. Included in these techniques were employee involvement, just-in-time inventory principles, partnering agreements with the local unions, high performance work organizations, and statistical process control, all designed to improve product quality, productivity, and asset utilization in the production of Harley-Davidson motorcycles.

Harley-Davidson uses just-in-time inventory to minimize inventories of raw materials and work in process, as well as scrap and rework costs. This system also allows quicker reaction to engineering design changes, quality improvements, and market demands.

Raw Material and Purchase Components[41]

Harley-Davidson worked hard to establish and/or reinforce long-term, mutually beneficial relationships with its suppliers. Through these collaborative relationships, it has gained access to technical and commercial resources for application directly to product design and development. Management anticipates the focus on collaboration and strong supplier manufacturing initiatives to lead to increased commitment from suppliers. This strategy has resulted in improved product quality, technical integrity, application of new features and innovations, reduced lead times for product development, and smoother/faster manufacturing ramp-up of new vehicle introductions. Harley's initiative to improve supplier productivity and component cost has been instrumental in delivering improvements in cost and in offsetting raw material price increases.

Harley-Davidson purchased all of its raw materials, principally steel and aluminum castings, forgings, sheets and bars, and certain motorcycle components, including carburetors, batteries, tires, seats, electrical components, and instruments. Given current economic conditions in certain raw material commodity markets, and pressure on certain suppliers due to difficulties in the automotive industry, Harley-Davidson monitors supply, availability, and pricing for both its suppliers and in-house operations.

Research and Development[42]

Harley-Davidson views research and development as a significant factor in its ability to lead the custom and touring motorcycling market and to develop products for the performance segment. The company's Product Development Center (PDC) brings employees from styling, purchasing, and manufacturing together with regulatory professionals and supplier representatives to create a concurrent product and process development team. Research and development expenses were $185.5 million, $177.7 million, and $178.5 million in 2007, 2006, and 2005, respectively.

Patents and Trademarks[43]

Harley-Davidson owns patents that relate to its motorcycles and related products and processes for their production. Harley-Davidson has increased its efforts to patent its technology and certain motorcycle-related designs and to enforce those patents. Management sees such actions as important as it moves forward with new products, designs, and technologies.

Trademarks are important to the Harley-Davidson's motorcycle business and licensing activities. It has a vigorous global program of trademark registration and enforcement to strengthen the value of the trademarks associated with its products and services, prevent the unauthorized use of those trademarks, and enhance its image and customer goodwill. It believes the HARLEY-DAVIDSON trademark and its Bar and Shield trademark are each highly recognizable by the public and are very valuable assets. The BUELL trademark is well known in performance motorcycle circles, as is the associated Pegasus logo. The company is making efforts to ensure that each of these brands will become better known as the Buell business expands.

Seasonality[44]

In general, Harley-Davidson has not experienced significant seasonal fluctuations in its sales. This has been primarily the result of a strong demand for the Harley-Davidson motorcycles and related products, as well as the availability of floor plan financing arrangements for its North American and European independent dealers. Floor plan financing allows dealers to build their inventory levels in anticipation of the spring and summer selling seasons. Harley-Davidson expressed its belief that efforts to increase the availability of its motorcycles has resulted in an increase in seasonality at its independent dealers. Over the last several years they have been working to increase the availability of its motorcycles at dealers to improve the customer experience.

Regulations[45]

Federal, state, and local authorities have various environmental control requirements relating to air, water, and noise pollution that affect the business and operations. Harley-Davidson endeavors to ensure that its facilities and products comply with all applicable environmental regulations and standards.

The motorcycles are subject to certification by the U.S. Environmental Protection Agency (EPA) for compliance with applicable emissions and noise standards and by the State of California Air Resources Board (CARB) with respect to CARB's more stringent emissions standards. Motorcycles sold in California are also subject to certain tailpipe and evaporative emissions standards that are unique to California. The EPA finalized a new tailpipe emissions standard for 2006 and 2010 respectively which are harmonized with the California emission standards. Additionally, Harley-Davidson motorcycles must comply with the emissions, noise, and safety standards of the European Union, Japan, and other international markets.

Harley-Davidson, as a manufacturer of motorcycle products, is subject to the National Traffic and Motor Vehicle Safety Act, which are administered by the National Highway Traffic Safety Administration (NHTSA). They have certified to NHTSA that their motorcycle products comply fully with all applicable federal motor vehicle safety standards and related regulations. Harley-Davidson has, from time to time, initiated certain voluntary recalls. During the last three years, Harley-Davidson initiated 15 voluntary recalls at a total cost of $10.8 million.

Employees[46]

As of December 31, 2007, the Motorcycles segment had approximately 9,000 employees. Unionized employees at the motorcycle manufacturing and distribution facilities in Wauwatosa, Menomonee Falls, Franklin, and Tomahawk, Wisconsin, and Kansas City, Missouri, are represented principally by the Paper Allied-Industrial Chemical and Energy Workers International Union (PACE) of the AFL-CIO, as well as the International Association of Machinist and Aerospace Workers (IAM). Production workers at the motorcycle manufacturing facility in York, Pennsylvania, are represented principally by the IAM. The collective bargaining agreement with the Pennsylvania-IAM will expire on February 2, 2010, the collective bargaining agreement with the Kansas City-USW and IAM will expire on July 30, 2012, and the collective bargaining agreement with the Wisconsin-USW and IAM will expire on March 31, 2008.

Approximately 50% of Harley-Davidson's 9,000 employees ride a Harley-Davidson. All employees, including Ziemer and Bluestein, go through a dealer to purchase their bike. This way, the employees see the customer experience firsthand.

Properties[47]

The following is a summary of the principal operating properties of Harley-Davidson as of December 31, 2007. Seven facilities that perform manufacturing operations: Wauwatosa and Menomonee Falls, Wisconsin, suburbs of Milwaukee (motorcycle powertrain production); Tomahawk, Wisconsin (fiberglass parts production and painting); York, Pennsylvania (motorcycle parts fabrication, painting and big-twin assembly); Kansas City, Missouri (Sportster assembly); East Troy, Wisconsin (Buell motorcycles assembly); Manaus, Brazil (assembly of select models for Brazilian market). (See **Exhibit 13**.)

Financial Services Segment[48]

The Financial Services segment has office facilities in Carson City, Nevada. Wholesale, insurance, and retail operations are in Plano, Texas, and European wholesale operations in Oxford, England. Ownership and lease structures are outlined in **Exhibit 13**.

Harley-Davidson and Buell[49]

Harley-Davidson Financial Services HDFS, operating under the trade name Harley-Davidson Credit, provides wholesale financial services to Harley-Davidson and Buell dealers and retail financing to consumers. HDFS, operating under the trade name Harley-Davidson Insurance, is an agent for the sale of motorcycle insurance policies and also sells extended service warranty agreements, gap contracts, and debt protection products.

Wholesale financial services include floor plan and open account financing of motorcycles and motorcycle parts and accessories, real estate loans, computer loans, and showroom remodeling loans. HDFS offers wholesale financial services to Harley-Davidson dealers in the United States, Canada, and Europe and during 2007; approximately 96% of such dealers utilized those services. The wholesale finance operations of HDFS are located in Plano, Texas, and Oxford, England.

Retail financial services include installment lending for new and used Harley-Davidson and Buell motorcycles. HDFS' retail financial services are available through most Harley-Davidson and Buell dealers in the United States and Canada. HDFS' retail finance operations are located in Carson City, Nevada, and Plano, Texas.

EXHIBIT 13
Principal Operating Facilities: Harley Davidson Inc.

Type of Facility	Location	Square Feet	Status
Corporate Office	Milwaukee, WI	515,000	Owned
Warehouse	Milwaukee, WI	24,000	Lease expiring 2009
Airplane Hanger	Milwaukee, WI	14,600	Owned
Manufacturing	Wauwatosa, WI	430,000	Owned
Product Development Center	Wauwatosa, WI	409,000	Owned
Distribution Center	Franklin, WI	250,000	Owned
Manufacturing	Menomonee Falls, WI	868,000	Owned
Product Development and Office	East Troy, WI	58,990	Lease expiring 2011
Manufacturing	East Troy, WI	40,000	Lease expiring 2011
Manufacturing	Tomahawk, WI	211,000	Owned
Office	Ann Arbor, MI	3,400	Lease expiring 2009
Office	Cleveland, OH	23,000	Lease expiring 2013
Manufacturing and Materials Velocity Center	Kansas City, MO	450,000	Owned
Materials Velocity Center	Manchester, PA	212,000	Owned
Manufacturing	York, PA	1,321,000	Owned
Motorcycle Testing	Talladega, AL	35,000	Lease expiring 2009
Motorcycle Testing	Naples, FL	82,000	Owned
Motorcycle Testing	Mesa, AZ	29,000	Lease expiring 2009
Office and Training Facility	Monterrey, Mexico	1,100	Lease expiring 2008
Office	Morfelden-Waldorf, Germany	22,000	Lease expiring 2008
Office and Warehouse	Oxford, England	21,000	Lease expiring 2017
Office	Liederdorp, The Netherlands	9,000	Lease expiring 2010
Office	Creteil, France	8,450	Lease expiring 2016
Office and Warehouse	Arese, Italy	17,000	Lease expiring 2009
Office	Zurich, Switzerland	2,000	Lease expiring 2009
Office	Sant Cugat, Spain	3,400	Lease expiring 2017
Warehouse	Yokohama, Japan	15,000	Lease expiring 2008
Office	Tokyo, Japan	14,000	Lease expiring 2008
Manufacturing	Adelaide, Australia	485,000	Lease expiring 2011
Office	Sidney, Australia	1,100	Lease expiring 2011
Office	Shanghai, China	1,700	Lease expiring 2008
Manufacturing and Office	Manaus, Brazil	30,000	Lease expiring 2009
Office	Chicaog, IL	26,000	Lease expiring 2022
Office	Plano, TX	61,500	Lease expiring 2014
Office	Carson City, NV	100,000	Owned
Storage	Carson City, NV	1,600	Lease expiring 2008
Office	Oxford, England	6,000	Lease expiring 2017

SOURCE: *Harley-Davidson, Inc., 2007 Form 10-K, p. 20.*

Motorcycle insurance, extended service contracts, gap coverage, and debt protection products are available through most Harley-Davidson and Buell dealers in the United States and Canada. Motorcycle insurance is also marketed on a direct basis to motorcycle riders.

Funding[50]

HDFS is financed by operating cash flow, advances, and loans from Harley-Davidson, asset-backed securitizations, commercial paper, revolving credit facilities, senior subordinated

debt, and redeemable preferred stock. HDFS also retains an interest in the excess cash flows from receivables and recognizes income on this retained interest. After the sale, HDFS performs billing and portfolio management services for these loans and receives a servicing fee for providing these services.

Competition[51]

The ability to offer a package of wholesale and retail financial services is a significant competitive advantage for HDFS. Competitors compete for business based largely on price and, to a lesser extent, service. HDFS competes based on convenience, service, brand association, strong dealer relations, industry experience, terms, and price.

During 2007, HDFS financed 55% of the new Harley-Davidson motorcycles retailed by independent dealers in the United States, as compared to 48% in 2006. Competitors for retail motorcycle finance business are primarily banks, credit unions, other financial institutions. In the motorcycle insurance business, competition primarily comes from national insurance companies and from insurance agencies serving local or regional markets. For insurance-related products such as extended service warranty agreements, HDFS faces competition from certain regional and national industry participants.

Seasonality[52]

In the northern United States and Canada, motorcycles are primarily used during warmer months, generally March through August. Accordingly, HDFS experiences significant seasonal variations. Retail customers typically do not buy motorcycles until they can ride them. From mid-March through August, retail financing volume increases and wholesale financing volume decreases as dealers deplete their inventories. From September through mid-March, there is a decrease in retail financing volume while dealer inventories build and turn over more slowly, substantially increasing wholesale financing volume.

Employees

At the end of 2007, the Financial Services segment had 755 employees, none of which were unionized.

Corporate Financial and Stock Price Performance

It appeared as though the weakened U.S. economy would stifle growth for Harley-Davidson. (**Exhibits 14 and 15** provide the company's income statement and balance sheet for the most recent five years. **Exhibit 16** provides a geographic breakdown of sales.) Since Harley went public, its shares have risen over 23,000% (through the end of 2006) but declined in 2007. As of February18, 2008, there were 90,748 shareholders of record of Harley-Davidson common stock (**Exhibit 17** provides a comparison of Harley-Davidson stock and the Standard and Poor's 500 since the 1986 initial public offering.) What does the future hold for Harley-Davidson? While trading near its five-year low, analysts considered two aspects of the Harley-Davidson product.

"It's an upper-middle-class toy," says Chad Hudson of the Prudent Bear fund, one of a number of prominent short-sellers convinced that Harley will skid. "As people run out of disposable income, that's going to hurt."[53]

"The risk is that retail trends may continue to weaken at Harley-Davidson, causing inventories to build. Harley-Davidson may then lower its production numbers," says analyst Gregory Badishkanian.[54]

EXHIBIT 14

Balance Sheet 2003–2007: Harley-Davidson Inc. (Dollar amounts in thousands)

Year Ending December 31	2007	2006	2005	2004	2003
Assets					
Current Assets:					
Cash and cash equivalents	$402,854	$238,397	$140,975	$275,159	$329,329
Marketable securities	2,475	658,133	905,197	1,336,909	993,331
Account receivable, net	181,217	143,049	122,087	121,333	112,406
Current portion of finance receivables, net	2,356,563	2,101,366	0	1,207,124	1,001,990
Inventories	349,697	287,798	221,418	226,893	207,726
Deferred income taxes	103,278	73,389	61,285	60,517	51,156
Prepaid expenses and other current assets	71,230	48,501	52,509	38,337	33,189
Total Current Assets	$3,467,314	$3,550,633	$1,503,471	$3,266,272	$2,729,127
Finance Receivables, net	845,044	725,957	600,831	488,262	735,859
Property, plant and equipment, net	1,060,590	1,024,469	1,011,612	1,024,665	1,046,310
Goodwill, net	61,401	58,800	56,563	59,456	53,678
Other Assets	222,257	172,291	72,801	94,402	358,114
Total Assets	$5,656,606	$5,532,150	$4,887,044	$4,933,057	$4,923,088
Liabilities & Shareholder's Equity					
Current Liabilities:					
Accounts Payable	$300,188	$283,477	$270,614	$244,202	$223,902
Accrued expenses and other liabilities	484,936	479,709	397,525	433,053	407,566
Current portion of finance debt	1,119,955	832,491	204,973	495,441	324,305
Total Current Liabilities	$1,905,079	$1,595,677	$873,112	$1,172,696	$955,773
Finance Debt	980,000	870,000	1,000,000	800,000	670,000
Other long-term liabilities	151,954	60,694	82,281	90,864	86,337
Postretirement healthcare benefits	192,531	201,126	0	149,848	127,444
Pension Liability	51,551	47,916	-	-	-
Deferred income taxes	-	-	155,236	51,432	125,842
Total Liabilities	$3,281,115	$2,775,413	$2,110,629	$2,264,840	$1,965,396
Shareholder's Equity:					
Common Stock	3,352	3,343	$3,310	$3,300	$3,266
Additional PIC	812,224	766,382	596,239	533,068	419,455
Retained Earnings	6,117,567	5,460,629	4,630,390	3,844,571	3,074,037
Accumulated other comprehensive income	(137,258)	(206,662)	58,653	(12,096)	47,174
Less:					
Treasury Stock	(4,420,394)	(3,266,955)	(2,204,987)	(1,150,372)	(586,240)
Total Shareholder's Equity	$2,375,491	$2,756,737	$3,083,605	$3,218,471	$2,957,692
Total Liabilities and Shareholder's Equity	$5,656,606	$5,532,150	$5,255,209	$5,483,293	$4,923,088

SOURCE: *Harley-Davidson, Inc., 2007 Form 10-K, page 60 and 2005 Form 10-K, page 53.*

How does Harley-Davidson move forward and continue to grow at the pace it has seen in the past? Is this a reasonable long-term growth rate? How does it maintain interest in the 2008 model bikes? How does it grapple with the aging baby boomers, who are generally the individuals who can afford a Harley-Davidson motorcycle? These were but a few of the questions in the minds of senior management as they did strategic planning.

EXHIBIT 15

Income Statement 2003–2007: Harley-Davidson Inc. (Dollar amounts in thousands)

Year Ending December 31,	2007	2006	2005	2004	2003
Net Sales	$5,726,848	$5,800,686	$5,342,214	$5,015,190	$4,624,274
COGS	3,612,748	3,567,839	3,301,715	3,115,655	2,958,708
Gross Profit	2,114,100	2,232,847	$2,040,499	$1,899,535	$1,665,566
Financial Services Income	416,196	384,891	331,618	305,263	279,459
Financial Services Interest and Operating Expense	204,027	174,167	139,998	116,662	111,586
Operating Income from Financial Services	212,169	210,724	191,620	188,600	167,873
Selling, Admin, and Engineering Expense	900,708	846,418	(762,108)	(726,644)	(684,175)
Income from Operations	1,425,561	1,597,153	$1,470,011	$1,362,491	$1,149,264
Investment Income, net	22,258	27,087	22,797	23,101	23,088
Other, net	-	-	(5,049)	(5,106)	(6,317)
Income before Provision for Income Taxes	1,447,819	1,624,240	$1,487,759	$1,380,486	$1,166,035
Provision for Income Taxes	513,976	581,087	528,155	489,720	405,107
Net Income	$933,843	$1,043,153	$959,604	$890,766	$760,928

SOURCE: *Harley-Davidson, Inc., 2007 Form 10-K, page 31, 2005 Form 10-K, page 52.*

EXHIBIT 16

Geographic Information: Harley-Davidson Inc. (Dollar amount in thousands)

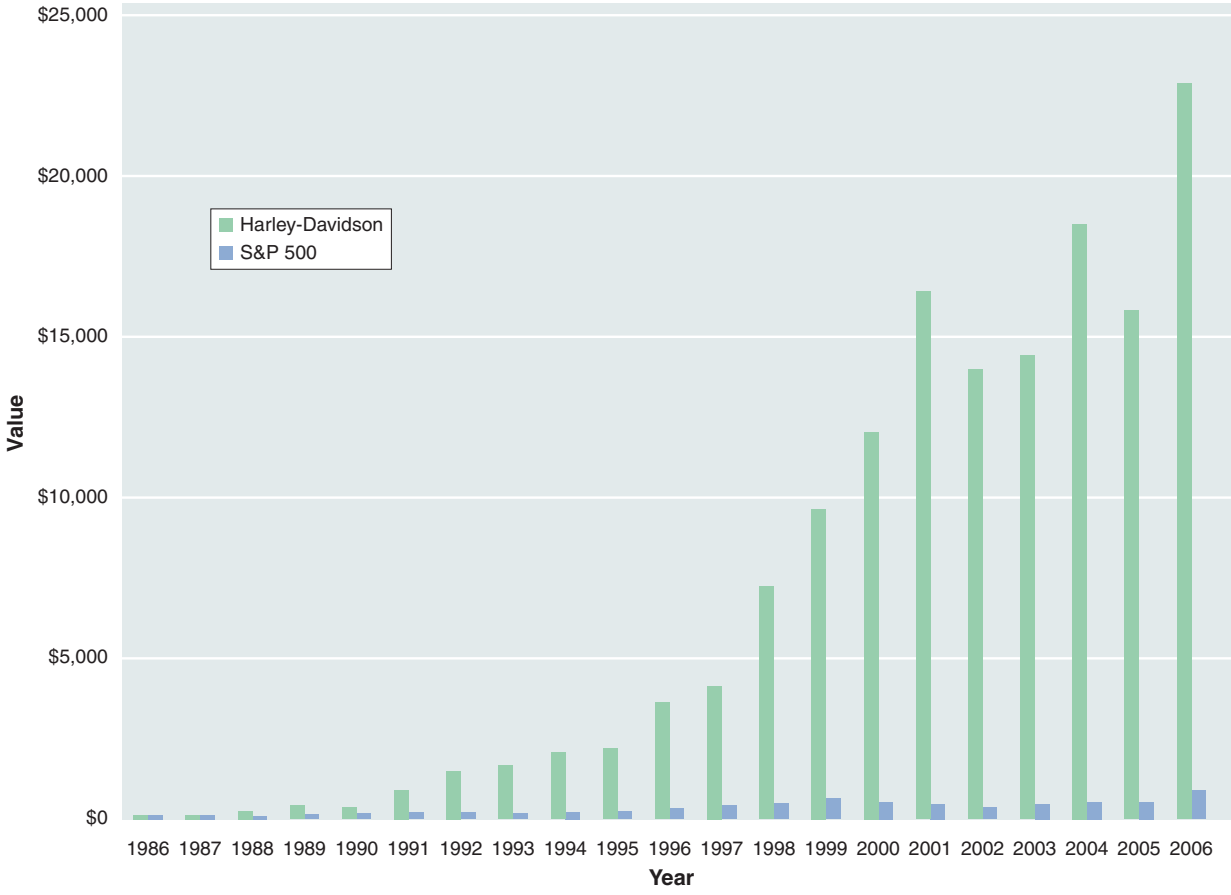
	2007	2006	2005	2004	2003
Net Revenue (1):					
United States	$4,208,016	$4,618,997	$4,304,865	$4,097,882	$3,807,707
Europe	790,150	621,069	530,124	477,962	419,052
Japan	229,759	207,884	192,268	192,720	173,547
Canada	230,230	188,993	143,204	136,721	134,319
Australia	162,689	82,792	—	—	—
Other foreign countries	106,004	80,951	171,753	109,905	89,649
Total	$5,726,848	$5,800,686	5,342,214	5,015,190	$4,624,274
Financial Services Income (1)					
United States	$381,001	$356,539	308,341	283,837	260,551
Europe	13,638	11,034	9,135	9,538	8,834
Canada	21,557	17,318	14,142	11,887	10,074
Total	$416,196	$384,891	331,618	305,262	279,459
Long-lived assets (2):					
United States	$1,173,169	$1,139,846	1,450,278	1,246,808	$1,400,772
Other foreign countries	66,988	56,214	38,002	44,300	41,804
Total	$1,240,157	$1,196,060	1,488,280	1,291,108	$1,442,576

Notes:
1. Net revenue and income is attributed to geographic regions based on location of customer.
2. Long-lived assets include all long-term assets except those specifically excluded under SFAS Number 131, such as deferred income taxes and finance receivables.

SOURCE: *Harley-Davidson 2007 Form 10-K, page 96, and 2005 Form 10-K, page 70.*

EXHIBIT 17

Year-End Market Value of $100 invested on December 31, 1986 through December 31, 2006: Harley-Davidson vs. SP 500



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44. Harley-Davidson, Form 10-K, 2007. The first paragraph was directly quoted with minor editing.

45. Harley-Davidson, Form 10-K, 2007. The first paragraph was directly quoted with minor editing.

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CASE 20

JetBlue Airways:

GROWING PAINS

S. S. George and Shirisha Regani

"We don't spend tens of millions of dollars telling people how cool we are. We put low fares out there and let them tell us."
DAVID NEELEMAN, THE FOUNDER AND THEN CEO OF JETBLUE, IN 2001[1]

"I do think they [JetBlue] had some growing pains. They were growing so fast they didn't have systems and redundancies in place."
MICHAEL MAGIERA, MANAGING DIRECTOR AT MANNING & NAPIER, A MONEY MANAGEMENT FIRM THAT OWNED JETBLUE STOCK, IN 2007[2]

A Change of Guard at JetBlue

IN MAY 2007, JETBLUE AIRWAYS INC. (JETBLUE), a low-cost carrier (LCC) based in New York, announced a new leadership structure for the company. David Barger (Barger), President and Chief Operating Officer (COO) of the airline, replaced David Neeleman (Neeleman) as CEO. Neeleman, who founded JetBlue in 1999, had been its CEO ever since. Under the new leadership structure, Neeleman was designated as the non-executive Chairman of the Board. Russell Chew, a former Federal Aviation Administration (FAA)[3] executive, took over as the COO; Barger retained his position as the President of the company.

Neeleman said at that time that the board's suggestion that he step down had nothing to do with the service breakdown that JetBlue had experienced in February 2007, when the northeast region of the United States had been hit by a severe snowstorm. The airline's slow reaction to the adverse weather had left thousands of passengers stranded at airports. In addition to having serious financial repercussions, this fiasco harmed JetBlue's image as a customer-friendly airline and tarnished its reliability record.

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Analysts greeted the leadership change positively. For several years after it was set up, JetBlue had been one of the most successful airlines in the United States, rivaling Southwest Airlines (Southwest)[4] in profitability and growth. However, it began facing various problems, both internal and external, in 2005–2006. Several analysts were of the opinion that JetBlue's growth in its early years had been too fast and unsustainable in the longer term, and that it was because of this that things started to come undone at the airline when the business environment changed.

Background

Business plans for setting up JetBlue were developed by Neeleman, along with lawyer Tom Kelly, in 1998. Neeleman raised $160 million[5] in capital from top investors such as Weston Presidio Capital, J.P. Morgan Partners, and Soros Private Equity Partners, and founded the airline in February 1999.

In September 1999, JetBlue was awarded 75 landing and takeoff slots at the John F. Kennedy International Airport (JFK) in New York, which was to serve as its base. The airline started commercial operations on February 11, 2000, with an inaugural flight from JFK to Fort Lauderdale airport in Florida.

Business Model

JetBlue's business was guided by five key values—safety, caring, integrity, fun, and passion. From its inception, it was "anti-establishment" and went against many of the accepted norms of the aviation industry. One example of this was its choice of New York, the biggest aviation market in the United States, as its base. LCCs in the United States typically avoided operating from New York because flying out of LaGuardia and Newark, the city's two domestic airports, was very expensive. Most domestic operators avoided JFK, as it mainly served international flights, and was also farther from Manhattan than the other two airports. Neeleman, however, reasoned that because JFK handled mostly international flights, JetBlue would face very little competition from domestic flights at that airport.

Positioning

From the beginning, JetBlue was positioned as a colorful and fun airline. Although it was designated as an LCC; it was in fact a "value player." The airline combined low fares with several value-added services that improved customer service without adding to operating costs.

All the planes operated at JetBlue were fitted with leather seats instead of cloth ones. Leather furnishings cost twice as much as cloth ones, but also lasted twice as long. Unlike typical LCCs, JetBlue provided assigned seating and allowed passengers to choose their seat on the plane whenever possible.

JetBlue served light snacks such as chips, cookies, and crackers, and coffee and canned drinks, which cost a fraction of a regular meal. The snacks were complimentary, unlike in LCCs that sold food to passengers. JetBlue estimated that it saved about $3 per passenger by choosing to serve sacks instead of regular food.

JetBlue provided free personal satellite television to all the passengers. The television sets reportedly cost only about $1 per passenger per flight—one-fourth the cost of a meal.

Operations

JetBlue's operations were the key to its low costs. JetBlue did not use old planes, but operated a fleet of new Airbus A-320[6] aircraft. The Airbus A-320s were chosen over the more popular Boeing-737s[7] (which Southwest used) because although they cost more initially, they

would be easier to maintain and were more fuel-efficient. The planes also came with a five-year warranty. Operating a uniform fleet of planes was also economical, as it reduced costs significantly in the areas of pilot training, maintenance, and spare parts.

All the aircraft were configured in a single class, with a uniform level of service. This also allowed JetBlue to put in the maximum number of seats possible in its planes.

Initially JetBlue did not try to fly too many routes, concentrating instead on the Northeast, the West Coast, and Florida—routes for which demand was high, and it was easy to undercut the fares of rivals. In addition, JetBlue also flew to secondary cities that were neglected by major carriers.

JetBlue flew mainly to secondary airports that did not handle too much air traffic. In this way, the airline was able to avoid congestion to a great extent and to establish a good on-time record. (In 2001–2002, JetBlue had an on-time performance record of 80 percent, as against the 72 percent for the top ten airlines in the United States.) Besides, secondary airports offered better business terms than the main ones.

JetBlue tried to operate the maximum possible number of flights per day. Its average turnaround time was 35 minutes, which was comparable to Southwest and much lower than that of full service airlines (FSAs), which took an hour or more to turn around. JetBlue also operated several "red-eye" flights.[8]

JetBlue flew only point-to-point flights, avoiding the hub-and-spoke model used by major carriers. This helped it avoid the complications that resulted from connecting flights and passenger transfers, and the airline was also able to operate with far fewer airport staff.

JetBlue used electronic ticketing extensively. Typically, more than 70 percent of the tickets were booked through the airline's Web site. JetBlue also cut down on the costs of back-end operations by allowing its call-center operators and customer service executives to work from home, using voice-over-Internet protocol.

Automation and the effective harnessing of technology further helped cut costs. JetBlue was the first airline to introduce paperless cockpits, where the pilots were equipped with laptops to access flight manuals and make the requisite calculations before takeoff. This saved between 15 and 20 minutes in takeoff. JetBlue was also one of the first airlines in the United States to allow automatic check-in and electronic baggage tagging. Automation helped JetBlue maintain a lean workforce (labor costs were historically the highest component of an airline's operating costs). In 2002, JetBlue's cost per available seat mile was 7 cents, which was 25 percent less than the average of the major carriers. JetBlue was thus able to offer fares that were typically 30 to 40 percent lower than other airlines.[9]

Culture

JetBlue was also one of the few airlines in the U.S. airline industry that had a non-unionized workforce. All the employees from the CEO down to the lowest ranking ones were called "crewmembers." The top management tried to create a family-like atmosphere at the airline.

JetBlue looked for a positive attitude in its employees, as they were often called on to do things that were outside their job descriptions. For instance, JetBlue did not employ cleaning crews to clean the flights—the flight attendants and sometimes the pilots were expected to pitch in to get the flight ready for the next takeoff. Airport ground staff also loaded or unloaded baggage from the flight. However JetBlue rewarded employees frequently with bonuses and profit sharing programs. Initiative was encouraged, and all employees were free to suggest ideas to cut costs and improve operations.

Because of the positive work culture, when customers flew JetBlue, they were impressed by the energy and attitude of the employees.

JetBlue also went out of its way to avoid inconveniencing customers. The airline had a policy of never canceling flights, (all through the early 2000s, JetBlue had an average

completion factor[10] of 99.5 percent). JetBlue also avoided overbooking flights. When there was a delay, passengers were informed well in advance. During extreme delays, JetBlue would hand out gift vouchers that could be redeemed for a future flight. All this was done even when the delay was because of uncontrollable factors.

JetBlue's passenger complaint numbers and baggage handling errors were among the lowest in the industry.

Growth and Expansion

JetBlue was founded during one of the most turbulent times in the history of civil aviation in the United States. September 11, 2001, terrorist attacks had hit the industry hard and any of the major airlines had either gone into bankruptcy protection, or were on the verge of doing so. In 2001, JetBlue planned to launch an IPO to fund its expansion plans.[11] The IPO had to be postponed in light of the terrorist attacks, but JetBlue continued with its expansion plans using its share of the $15 billion bailout ($5 billion in direct compensation and another $10 billion in loan guarantees)[12] the U.S. government granted the aviation industry, and a fresh infusion of funds from its original investors.

JetBlue was one of the first airlines to take a proactive approach to increase safety on aircraft. It was the first national carrier to install bulletproof, deadbolted cockpit doors on its aircraft, even before the FAA mandated their use. The airline also installed screens in the cockpit so that pilots could see what was happening in the passenger cabins.

JetBlue's message to customers after September 11 also set it apart from other airlines. It ran a newspaper advertisement that said: "We know you need time to heal. JetBlue will be here when you're ready to fly again."[13] For a few weeks after flights resumed, JetBlue aircraft flew almost empty from New York to the 17 destinations it served at that time, but the airline did not scale back operations.

Soon after the September 11 attacks, JetBlue's management identified the routes on which other airlines had cut capacity. For instance, most of the major airlines had cut down their flights from New York to Florida. JetBlue boosted its services to Florida, adding seven new flights per week on this route within a few months. JetBlue also ordered three new A-320 aircraft in 2001. JetBlue was one among only three airlines in the United States (the other two being Southwest and AirTran Airways [AirTran]) to post a profit in 2001 (The company posted a profit of $38.5 million, up from a loss of $21.3 million in 2000.)[14] (See **Exhibit 1** for JetBlue's annual income statements from 2002 to 2006.)

In April 2002, JetBlue launched an IPO of 5.87 million shares, raising $158 million.[15] That year, JetBlue started expanding operations on the West Coast, using Los Angeles as a second hub.

In late 2002, JetBlue acquired 100 percent ownership of LiveTV, the company that maintained its in-flight satellite TV channels, for $41 million in cash and the retirement of $39 million in debt.[16] It also started a customer loyalty program, TrueBlue, in mid-2002, collecting nearly 40,000 members by the end of the year. In 2002, JetBlue's cost per available seat mile (CASM)[17] was 6.43 cents, lower than all the other major U.S. airlines, which reported an average CASM of 9.58 cents.[18] (See **Exhibit 2** for JetBlue's key operating statistics from 2002 to 2006.)

In 2003, JetBlue placed an order for 100 Embraer-190[19] regional jets for a price of $3 billion, with options for another 100 planes[20] to serve more regional routes as a part of its expansion plans. (This was in addition to the 16 A-320 aircraft added to the fleet that year, with an order for 65 more, and options on another 50.[21]) The A-320 aircraft were configured in a 162-seat arrangement, while the Embraer aircraft, which were configured with 100 seats, were a more suitable size for regional routes. The first Embraer planes entered service in October 2005.

EXHIBIT 1
Annual Income Statements: JetBlue Airways

(Dollar amounts in millions except per share data)

Year Ending	2006	2005	2004	2003	2002
Operating Revenues	**$ 2,363**	**$ 1,701**	**$ 1,265**	**$ 998**	**$ 635**
Operating Expenses					
Salaries, wages, and benefits	553	428	337	267	162
Aircraft fuel	752	488	255	147	76
Landing fees and other rents	158	112	92	70	44
Depreciation and amortization	151	115	77	51	27
Aircraft rent	103	74	70	60	41
Sales and marketing	104	81	63	54	44
Maintenance materials and repairs	87	64	45	23	9
Other operating expenses[1]	328	291	215	159	127
Total operating expenses[2]	**2,236**	**1,653**	**1,154**	**831**	**530**
Operating income	127	48	111	167	105
Government compensation[3]	—	—	—	23	—
Other income (expense)	(118)	(72)	(36)	(16)	(10)
Income (loss) before income taxes	9	(24)	75	174	95
Income tax expense (benefit)	10	(4)	29	71	40
Net income (loss)	**$ (1)**	**$ (20)**	**$ 46**	**$ 103**	**$ 55**
Earnings (Loss) Per Common Share					
Basic	$ —	$ (0.13)	$ 0.30	$ 0.71	$ 0.49
Diluted	$ —	$ (0.13)	$ 0.28	$ 0.64	$ 0.37
Other Financial Data					
Operating margin	5.4%	2.8%	8.8%	16.8%	16.5%
Pre-tax margin	0.4%	(1.4)%	5.9%	17.4%	15.0%
Ratio of earnings to fixed charges[4]	—	—	1.6x	3.1x	2.7x
Net cash provided by operating activities	$ 274	$ 170	$ 199	$ 287	$ 217
Net cash used in investing activities	(1,307)	(1,276)	(720)	(987)	(880)
Net cash provided by financing activities	1,037	1,093	437	789	657

Notes:
[1]In 2006, we sold five Airbus A320 aircraft, which resulted in a gain of $12 million.
[2]In 2005, we recorded $7 million in non-cash stock-based compensation expense related to the acceleration of certain employee stock options and wrote-off $6 million in development costs relating to a maintenance and inventory tracking system that was not implemented.
[3]In 2003, we received $23 million in compensation under the Emergency War Time Supplemental Appropriations Act.
[4]Earnings were inadequate to cover fixed charges by $17 million and $39 million for the years ended December 31, 2006, and 2005, respectively.

SOURCE: *JetBlue Airways Annual Report 2006.*

In 2003, JetBlue received permission to build a new terminal at JFK, giving it 26 more gates. (Construction of the terminal began in late 2005.) In 2004, JetBlue announced that it planned to take delivery of one new Airbus A320 every three weeks and to hire five crew members per day during the year.[22]

During 2004, JetBlue performed well on many operating metrics, with a 99.4 percent completion factor, the highest on-time performance of 81.6 percent in the industry, and the fewest baggage mishandlings of 2.99 per 1,000 customers boarded. Its CASM also remained lower than the industry average at 6.10 cents.[23] By the end of 2004, JetBlue flew to 30 destinations, including one international destination—the Dominican Republic—launched that year. (See **Exhibit 3** for JetBlue's growth between 2000 and 2006.)

EXHIBIT 2
Operating Statistics: JetBlue Airways[1]

	2006	2005	2004	2003	2002
Revenue passengers[2] (thousands)	18,565	14,729	11,783	9,012	5,752
Revenue passenger miles[3] (millions)	23,320	20,200	15,730	11,527	6,836
Available seat miles[4] (ASMs) (millions)	28,594	23,703	18,911	13,639	8,240
Load factor[5]	81.6%	85.2%	83.2%	84.5%	83.0%
Breakeven load factor[6, 5]	81.4%	86.1%	77.9%	72.6%	71.5%
Aircraft utilization[7] (hours per day)	12.7	13.4	13.4	13.0	12.9
Average fare[8]	$ 119.73	$ 110.03	$ 103.49	$ 107.09	$ 106.95
Yield per passenger mile[9] (cents)	9.53	8.02	7.75	8.37	9.00
Passenger revenue per[10] ASM (cents)	7.77	6.84	6.45	7.08	7.47
Operating revenue per[11] ASM (cents)	8.26	7.18	6.69	7.32	7.71
Operating expense per[12] ASM (cents)	7.82	6.98	6.10	6.09	6.43
Operating expense per ASM, excluding fuel[13] (cents)	5.19	4.92	4.75	5.01	5.51
Airline operating expense per ASM (cents)[1]	7.76	6.91	6.04	6.08	6.43
Departures	159,152	112,009	90,532	66,920	44,144
Average stage length[14] (miles)	1,186	1,358	1,339	1,272	1,152
Average number of operating aircraft during period	106.5	77.5	60.6	44.0	27.0
Average fuel cost per gallon[15]	$ 1.99	$ 1.61	$ 1.06	$ 0.85	$ 0.72
Fuel gallons consumed (millions)	377	303	241	173	106
Percent of sales through jetblue.com during period	79.1%	77.5%	75.4%	73.0%	63.0%
Full-time equivalent employees at period end[5]	9,265	8,326	6,413	4,892	3,572

Notes:
[1]Excludes results of operations and employees of LiveTV, LLC, which are unrelated to our airline operations and are immaterial to our consolidated operating results.
[2]"Revenue passengers" represents the total number of paying passengers flown on all flight segments.
[3]"Revenue passenger miles" represents the number of miles flown by revenue passengers.
[4]"Available seat miles" represents the number of seats available for passengers multiplied by the number of miles the seats are flown.
[5]"Load factor" represents the percentage of aircraft seating capacity that is actually utilized (revenue passenger miles divided by available seat miles).
[6]"Breakeven load factor" is the passenger load factor that will result in operating revenues being equal to operating expenses, assuming constant revenue per passenger mile and expenses.
[7]"Aircraft utilization" represents the average number of block hours operated per day per aircraft for the total fleet of aircraft.
[8]"Average fare" represents the average one-way fare paid per flight segment by a revenue passenger.
[9]"Yield per passenger mile" represents the average amount one passenger pays to fly one mile.
[10]"Passenger revenue per available seat mile" represents passenger revenue divided by available seat miles.
[11]"Operating revenue per available seat mile" represents operating revenues divided by available seat miles.
[12]"Operating expense per available seat mile" represents operating expenses divided by available seat miles.
[13]"Operating expense per available seat mile, excluding fuel" represents operating expenses, less aircraft fuel, divided by available seat miles.
[14]"Average stage length" represents the average number of miles flown per flight.
[15]"Average fuel cost per gallon" represents total aircraft fuel costs, which excludes fuel taxes, divided by the total number of fuel gallons consumed.

SOURCE: *JetBlue Airways Annual Report 2006.*

However, in the fourth quarter of 2004, JetBlue recorded a drastic drop in profits. It announced a net income of $2.3 million compared to $19.54 million in the corresponding quarter of the previous year.[24] The drop in earnings was attributed to increased operating expenses as a result of a rise in fuel prices. The airline ended the year with a net income of $46 million, on revenues of $1.2 billion.[25] Following this, it was recognized as a "major airline" by the DOT.

EXHIBIT 3
JetBlue's Growth

Year	Destinations	Employees[1]	Operating Aircraft		
			Owned	Leased	Total
2000	12	1174	4	6	10
2001	18	2361	9	12	21
2002	20	4011	21	16	37
2003	21	5433	29	24	53
2004	30	7211	44	25	69
2005	33	9021	61	31	92
2006	49	10,377	70	49	119

Note: [1]Employees include full time and part time employees.

SOURCE: *JetBlue Airways Annual Report 2006.*

Turbulent Times

JetBlue's performance in all the quarters of 2005 was considerably poorer than in the corresponding quarters of 2004, and in the fourth quarter of 2005, it posted a quarterly loss for the first time since its IPO. JetBlue ended the year with its first annual loss of $20 million on revenues of $1.7 billion. The airline's operating margins fell to 2.8 percent from 8.8 percent in 2004.[26]

JetBlue's performance statistics also showed a downward trend, and in 2005, the airline's on-time performance record fell to 71.4 percent, which was lower than almost all the major airlines in the United States. The turbulence continued into 2006, and JetBlue announced a loss in the first quarter of that year. JetBlue's problems were attributed to a combination of several internal and external factors.

Rising Fuel Costs

Fuel prices around the world experienced a sudden rise in 2004. Among the worst affected sectors was aviation. Fuel was the second major expense in an airline's operations after labor in the United States, and typically constituted between 10 percent and 14 percent of an airline's operating expenses. However, after the price increases, its share in operating expenses became more than 20 percent. (See **Exhibit 4** for the breakup of an airline's operating expenses in 2007.) Although the rise in fuel prices affected all airlines, its effect on LCCs such as JetBlue was greater.

In 2005, fuel prices increased by nearly 50 percent over 2004. But even as fuel prices pushed up operating expenses, JetBlue was unable to increase its fares significantly. The growing number of LCCs in the aviation industry, and the attempts of the FSAs to take away market share from the LCCs had led to a fall in the average fares. The average price for a passenger to fly a mile fell by more than 10 percent between 2000 and 2006 (see **Exhibit 5**). Added to this, JetBlue had hedged only 20 percent of its fuel requirements for 2005 at $30 per barrel, compared to the 42 percent hedged in 2004.[27] By 2005, fuel constituted nearly 30 percent of JetBlue's operating expenses, compared to 14.4 percent in 2002. It exceeded 33 percent in 2006 (see **Exhibit 6**).

EXHIBIT 4
Break-Up of an Airline's Operating Costs (as of 1Q2007): JetBlue Airways

Passenger Airline Cost Index First Quarter 2007	Index (2000 = 100)	% of Operating Expenses
Labor per FTE	111.1	24.5
Fuel per gallon	276.9	23.4
Aircraft ownership per operating seat	79.5	7.5
Non-aircraft ownership per enplanement	108.5	4.7
Professional services per ASM	114.9	8.6
Food & beverage per RPM	59.6	1.5
Landing fees per capacity ton landed	137.3	2.0
Maintenance material per revenue aircraft hour	53.7	1.3
Aircraft insurance as % of hull net book value	97.9	0.1
Non-aircraft insurance per rpm	221.0	0.5
Passenger commissions as % of passenger revenue	29.5	1.2
Communication per enplanement	71.0	0.9
Advertising & promotion per RPM	66.5	0.8
Utilities & office supplies per FTE	96.3	0.7
Transport-related per ASM	399.8	13.9
Other operating per RTM	111.6	8.3
Interest as % of outstanding debt	114.1	—
Composite[1]	**182.9**	**100.0**

Note: [1]Although interest is a non-operating expense, it is factored into the composite cost index to capture the role of debt in the provision of air service. It is *not* included in the composite cost per ASM or share of operating expenses.

SOURCE: *http://www.airlines.org.*

EXHIBIT 5
Increases in Fuel Price—Jet Fuel

Year	Cost of Domestic Air Travel (cents per mile)[1]	U.S. Jet Fuel (cents per gallon)	U.S. CPI (1982–84) = 100
2000	14.57	90.0	172.2
2001	13.25	75.0	177.1
2002	12.00	70.8	179.9
2003	12.29	88.2	184.0
2004	12.03	120.8	188.9
2005	12.29	172.2	195.3
2006	13.00	196.8	201.6
2006 vs. 2000	−10.8%	+118.7%	+17.1%

Note: [1]Excludes government-imposed taxes and fees

SOURCE: *http://www.airlines.org/economics/energy/.*

EXHIBIT 6
Fuel Price History: JetBlue Airways

Year Ending December 31	2006	2005	2004	2003	2002
Gallons consumed (millions)	377	303	241	173	105
Total cost ($ millions)	752	488	255	147	76
Average price per gallon	1.99	1.61	1.06	0.85	0.72
Percent of operating expenses %	33.6	29.5	22.1	17.8	14.4

SOURCE: *Compiled from JetBlue's Annual Reports.*

Industry Factors

In the period between 2001 and 2003, when JetBlue's growth was at a peak, most of the major airlines in the United States were suffering from the adverse effects of the September 11 attacks. JetBlue had taken advantage of its competitors' weakened state to boost its own growth. However, by 2004–2005, many of the airlines that were operating under Chapter 11[28] began to recapture market share. These airlines were able to undercut competition by offering very low fares, taking advantage of the protection of the bankruptcy laws. "It's too much competition from companies that are purposely allowing themselves to lose money. Companies in bankruptcy right now, such as United and US Air, have been significantly slashing their own fares," said Rick DiLisi, a spokesman for Independence Air, a low-cost airline based in Virginia.[29] JetBlue was also affected by the low fares offered by United Airlines (United) and Delta Air Lines (Delta), both of which were operating under bankruptcy protection at the time, on transcontinental routes, American Airlines (American) and Continental Airlines (Continental), which had escaped Chapter 11, also become aggressive about defending market share, and launched several new transcontinental flights at low prices.

In 2003, JetBlue launched flights from Atlanta to Los Angeles, one of the busiest routes in the United States. Atlanta was Delta's hub, and when JetBlue entered the market, Delta responded by instantly adding capacity and lowering prices on this route. It also added routes to other destinations in California, quickly establishing its dominance in the region. AirTran, another LCC that operated from Atlanta, also responded aggressively by leasing new planes to increase capacity. Eventually, JetBlue was forced to withdraw from Atlanta in December 2003, just seven months after it started its operations there.

Legacy carriers also launched low-cost subsidiaries of their own, in an effort to compete with the growing number of LCCs. Delta launched an LCC called Song in April 2003, to compete directly with JetBlue. Song was also based at JFK, and flew many of the same routes as JetBlue. Like JetBlue, Song also offered amenities such as leather seats, and a free personal entertainment system at every seat. It also served beverages, but charged for meals and liquor. The airline was promoted heavily, and for a few months was successful in capturing a large part of JetBlue's business on the New York to Florida route. However, its financial performance was not satisfactory and it was eventually integrated into Delta's mainline service in April 2006.

United also launched an LCC called "Ted" in February 2004. Although Ted was designed more along the lines of the traditional LCC model and did not serve food, it provided in-flight entertainment in the form of inflight music and videos. Ted operated mainly on central and western routes in the United States. According to analysts, the success of Ted was one of the main reasons why United was able to emerge from bankruptcy in February 2006.

Song and Ted had an advantage over the other LCCs, in that they allowed passengers to connect to the flights of their parent airlines, which had far bigger route networks than any of the LCCs. They also shared the frequent flier programs of their parents, and had access to the gates and landing/takeoff slots of their parents in large airports.

JetBlue also faced competition from LCCs such as Southwest, AirTran, America West, Spirit Airlines (Spirit), and Frontier Airlines (Frontier). Although none of these airlines offered the same kind of service as JetBlue, all of them were well established in their home markets, and had loyal customer bases. Southwest especially had the lowest cost even among the LCCs, and was very popular among passengers who were willing to give up in-flight services for cheap tickets. AirTran and Spirit operated two classes on their flights and targeted business passengers successfully with their low-fare Business Classes. With the exception of Southwest and Spirit, all the LCCs also offered some form of in-flight entertainment, although AirTran was the only other airline that offered it free.

Internal Factors

When JetBlue had first started operations, it had used new planes and fittings, which did not cost much in terms of maintenance. However, a few years later, as the fleet aged, maintenance costs began to rise. Further, JetBlue had to employ more people to meet its requirements, and also give pay increases to people who had been with the airlines for several years. In an effort to differentiate itself from its competitors, JetBlue had also kept adding new in-flight services. In 2003, the airline changed the configuration of its A-320 aircraft, removing one row of seats from the plane, in order to improve legroom for passengers (the number of seats was brought down to 156, from 162[30]). While this made the aircraft more comfortable for passengers, it also lowered JetBlue's revenue earning capacity. However, the move was expected to cut fuel costs, due to the lower weight of the aircraft.

In 2005, JetBlue upgraded its seatback televisions. All the new aircraft were fitted with larger TVs, and all the old aircraft were retrofitted. At the same time, the airline also equipped all its planes with XM Satellite radio, and increased the size of the overhead bins on the aircraft.

Most LCCs gave complimentary beverages and sold food, or served complimentary refreshments in strictly measured quantities. But JetBlue offered a range of complimentary snacks and beverages in unlimited quantities. Although the airline started out serving chips, cookies, and coffee, over the years it added several items to its line of in-flight refreshments. As of 2007, the airline offered a range of hot and cold beverages and several varieties of snacks. It also sold a variety of cocktails at $5 each.

Passengers traveling on red-eye flights were given complimentary spa amenity kits containing mint lip balm, body butter, an eyeshade, and ear plugs. JetBlue also set up a complimentary snack bar in the plane for overnight flights, and passengers were given complimentary hot towels, Dunkin Donuts coffee or tea, orange juice or bottled spring water, just before they landed the next morning.

Another issue was the problems that JetBlue experienced with its new Embraer-190 aircraft that entered service in late 2005. JetBlue faced a lot of glitches in integrating the new aircraft into its operations. To begin with, Embraer delivered the planes two weeks behind schedule, which caused several flight delays and cancellations. Second, JetBlue's employees lacked familiarity with the planes. Third, the Embraer-190 had some technical issues that caused several delayed flights and significantly lowered JetBlue's aircraft utilization rates. In the opinion of some analysts, JetBlue had been too optimistic in placing such a large order for the untried Embraer planes. After two consecutive losses in the last quarter of 2005 and the first quarter of 2006, several analysts started comparing JetBlue to People Express Airlines,[31] a low-cost airline operated in the United States between 1981 and 1987.

The Return to Profitability Plan

In April 2006, soon after announcing the first quarter loss, Neeleman and Barger announced a recovery plan for JetBlue called the "Return to Profitability" plan (RTP). The main aims of the RTP were revenue optimization, improved capacity management, cost reduction, and retaining the commitment to deliver high-quality service on every flight.

As a part of the revenue optimization goal, JetBlue announced that it would reduce the number of long-haul flights and shift its focus back to short-to-medium routes. The company said that it planned to reduce the ratio of long-haul to non–long-haul flights from 1.5:1 in 2005, to 1.2:1 during 2006. JetBlue also said that it would offer fewer tickets at very low fares and more tickets at mid-level fares on all its routes to improve the mix of fares in its revenues. The average fare was expected to rise to at least partly reflect the increased fuel prices. During 2006, JetBlue increased its lowest transcontinental fare from $349 to $399.

JetBlue also committed itself to conducting a careful scrutiny of its yield management practices to ensure it did not sacrifice revenues to increase the load factor.[32] Trying to increase the load factor put stress on an airline's operations and also led to delays as the airlines tried to get as many passengers on board as possible, even minutes before a flight's scheduled departure. In 2005, JetBlue's load factor was 85.2 percent and the yield per passenger mile was 8.02 cents. This changed to a load factor of 81.6 percent and yield per passenger mile[33] of 9.53 cents in 2006, which was nearly a 19 percent increase in yield per passenger mile over the previous year.[34]

The RTP also committed JetBlue to manage capacity better by cutting it on unprofitable routes, and adding it on high-demand routes. During 2006, JetBlue added only 21 percent capacity, instead of the previously projected 28 percent. The capacity on the New York—Florida route was cut by 15 percent, while the New York—Los Angeles route saw an 8 percent reduction in capacity.

On the other hand, JetBlue introduced short-haul routes from Boston to Washington, New York to Richmond, and Boston to Richmond; and medium-haul routes from New York to Austin, Boston to Austin, and Boston to Nassau. The airline introduced nonstop service on two high-demand long-haul routes from Burbank (California) to Orlando (Florida) and Boston to Phoenix (Arizona). On the whole, JetBlue added 16 new destinations during 2006, which mainly involved "connecting the dots" between its existing destinations using the Embraer-190 aircraft.

JetBlue sold five of its oldest A-320 aircraft during 2006, and deferred the delivery of 12 A-320 aircraft that had originally been planned for 2007–2009, to 2011–2012. The options the airline held on the A-320s were also adjusted. (See **Exhibit 7**.)

JetBlue also increased its focus on cost management. The airline managed to control its distribution cost by achieving 80 percent of its bookings through its website in 2006—the highest in the U.S. airline industry. It also implemented several initiatives to conserve fuel and improve fuel efficiency, especially by using single-engine taxi techniques, utilizing ground power units, and identifying ways to remove excess weight from the aircraft. In late 2006, JetBlue announced it would remove one more row of seats from its A-320 aircraft, bringing the total seat number down to 150.

In addition to this, JetBlue was also putting in efforts to improve the efficiency of its crew members and was trying to accomplish more with fewer full-time employees per aircraft than before. The elimination of one row of seats allowed JetBlue to operate each flight with three attendants instead of four, as federal regulations require one flight attendant for every 50 passengers. JetBlue also began to go slow on hiring people for non-operational positions. Better flight scheduling practices were also implemented to control costs. JetBlue started charging for some premium services. For instance, the company changed some of its refund policies, and increased the fees it charged for flying unaccompanied minors and the cancellation charges on confirmed flights.

EXHIBIT 7
JetBlue's A-320 Order Adjustments

	2007	2008	2009	2010	2011	2012	2013
Firm Orders Original	17	17	18	18	12	0	0
Adjusted to	12	12	16	18	18	6	0
Change	(5)	(5)	(2)	0	6	6	0
Options Original	0	2	2	2	9	20	15
Adjusted to	0	2	4	4	6	16	18
Change (%)	0	0	2	2	(3)	(4)	3

SOURCE: *http://investor.jetblue.com.*

EXHIBIT 8
A Snapshot of Jetblue's Quarterly Performance (dollar amount in millions)

Period Ending On	March 31, 2006	June 30, 2006	September 30, 2006	December 31, 2006	March 31, 2007	June 30, 2007
Operating Revenues	490	612	628	633	608	730
Operating Expenses	515	565	587	569	621	657
Operating Income (loss)	(25)	47	41	64	(13)	73
Other Income (expense)	(22)	(22)	(40)	34	(32)	(30)
Income Tax Expense (benefit)	(15)	11	1	13	(23)	22
Net Income	(32)	14	-	17	(22)	21

Compiled from JetBlue's Annual Report 2006 and 10K filings with the SEC.

The RTP started showing results by the end of 2006. In the fourth quarter of 2006, JetBlue posted a profit of $17 million on revenues on $633 million, compared to a loss of $42 million in the corresponding quarter of the previous year. Analysts had expected the company to return to profitability only in the first quarter of 2007. (See **Exhibit 8** for JetBlue's quarterly results in 2006 and 2007.) JetBlue ended 2006 with a net loss of $1 million, compared to a loss of $20 million in 2005. The operating margin also increased to 5.4 percent in 2006, compared to 2.8 percent in 2005.[35] The airline expected that the combination of higher revenues and lower costs would help it achieve savings of around $70 million by the end of 2007.[36]

The Customer Service Fiasco

Even as its financial performance started showing signs of improvement, JetBlue faced another crisis in February 2007, when a snowstorm hit the Northeast and Midwest regions of the United States, throwing the airline's operations into chaos.

Because JetBlue followed the practice of never canceling flights, even when the ice storm hit and the airline was forced to keep several flights on the ground, it desisted from calling them off. Because of this, passengers were kept waiting at airports for their flight to take off. In some cases, passengers who had already boarded their planes were kept waiting on the tarmac for several hours and not allowed to disembark. In one extreme instance, passengers were stranded on board a plane on the tarmac at JFK for 11 hours. However, after all this, the airline was eventually forced to cancel most of its flights because of bad weather.

Even after the storm cleared, JetBlue struggled to get back on its feet as the canceled flights had played havoc with its systems, which were not equipped to deal with cancellation. The airline's poor database management systems resulted in major problems in tracking and lining up pilots and flight crew who were within federal regulation limits for the number of flying hours to operate the resumed flights. In addition, the delays and cancellations had caused a baggage crisis, with several passengers losing their luggage. The airline had to give all its passengers full refunds if their flights were canceled, or rebook them on new flights, which added to the complications.

The airline had canceled nearly 1,200 flights in the days following the storm and it took several days of its operations to get back to even keel. In contrast, American, Continental, and Delta, which had canceled flights immediately after the storm broke, were able to resume operations more quickly. The fiasco reportedly cost JetBlue $30 million (which included $10 million in refunding tickets for canceled flights, $16 million for issuing travel vouchers, and $4 million for incremental costs, such as hiring overtime crews).[37]

Notwithstanding the financial loss, the loss of goodwill was expected to be much more serious for JetBlue. Traditionally, JetBlue had had one of the lowest rates of consumer complaints filed with the DOT.[38] It also usually ranked high on customer service.[39] But following the fiasco, *BusinessWeek*, a prominent business magazine, pulled JetBlue off its list of Customer Service Champs, published early in 2007. JetBlue was to have held the #4 spot on the list compiled from consumer responses from the first half of 2006.

Some analysts felt that JetBlue had taken its low-cost philosophy too far in having failed to set up the necessary systems to support its rapid growth. Following the fiasco, JetBlue published apology letters in the *New York Times* and *USA Today*, among other places. Neeleman also apologized during his appearances on the *Late Show with David Letterman* on the CBS Network, and on YouTube. "We should have acted quicker," said Neeleman. "We should have called the Port Authority quicker. These were all lessons learned from that experience."[40]

In late February 2007, Neeleman unveiled a "Customer Bill of Rights," which laid out the airline's policy on compensating passengers for delays and cancellations (see **Exhibit 9**). Additionally, JetBlue launched a new database management system to help it track crew and baggage better, and upgraded its Web site to allow online re-bookings. Employees at the airline's headquarters were being trained to help out with operations at the airport in emergency situations. JetBlue also became more proactive during bad weather conditions in the months following the storm. In March 2007, when bad weather hit the East Coast once again, JetBlue was one of the first airlines to cancel flights to and from airports on the East Coast. The airline reportedly canceled nearly 230 flights during this time.

According to analysts, JetBlue's handling of the events following the crisis was likely to go a long way in redeeming it in the eyes of the public. "The single most important thing a company needs to show in a crisis is that it cares. That's not a feeling. It's a behavior," said Bruce Blythe, the CEO of Crisis Management International[41, 42]. Several consumer polls conducted after the February 2007 crisis also showed that JetBlue's popularity with passengers continued to remain high. The crisis and its repercussions were expected to put a burden on JetBlue's already strained finances. But JetBlue managed to return to profitability in the second quarter of 2007, after a first quarter loss of $22 million.

More Turbulence Ahead?

Analysts felt that the appointment of Barger as the new CEO was likely to benefit JetBlue. According to them, the fresh leadership was likely to help JetBlue through its growing pains and provide it with a positive direction for the future. They also pointed out that Barger differed considerably from Neeleman in his leadership style. (Barger was thought to be more organized than Neeleman, and much more focused on operational issues than the latter, who enjoyed strategizing.)

However, JetBlue was likely to face many more challenges in the future than it had faced during the first few years of operations. The FSAs, most of which recovered by 2007, were ready to defend their turf against LCCs. Delta had launched a big sale of discounted tickets during the Thanksgiving weekend in 2006, triggering a price war in the industry.

In addition to this, JetBlue was likely to face competition from other LCCs such as AirTran and Frontier, which had formed an alliance in late 2006, to combine their marketing and mileage programs.[43] Competition was also expected from new airlines like Virgin America, which had been launched amidst a lot of buzz in August 2007, and was positioned as a "value" carrier. Like JetBlue, Virgin America also tried to attract passengers with amenities such as satellite TV, mood lighting, onboard self-service mini bar, and meals-on-demand. Virgin America had announced that it expected to expand to 10 cities within a year of operation and to up to 30 cities within five years.[44]

EXHIBIT 9
Jetblue's Customer Bill of Rights

INFORMATION
JetBlue will notify customers of the following:

- Delays prior to scheduled departure
- Cancellations and their cause
- Diversions and their cause

CANCELLATIONS
All customers whose flight is canceled by JetBlue will, at the customer's option, receive a full refund or reaccommodation on a future JetBlue flight at no additional charge or fare. If JetBlue cancels a flight within 12 hours of scheduled departure and the cancellation is due to a Controllable Irregularity, JetBlue will also provide the customer with a Voucher valid for future travel on JetBlue in the amount paid by the customer for the roundtrip (or the oneway trip, doubled).

DEPARTURE DELAYS

- Customers whose flight is delayed prior to scheduled departure for 1–1:59 hours due to a Controllable Irregularity are entitled to a $25 Voucher good for future travel on JetBlue.
- Customers whose flight is delayed prior to scheduled departure for 2–3:59 hours due to a Controllable Irregularity are entitled to a $50 Voucher good for future travel on JetBlue.
- Customers whose flight is delayed prior to scheduled departure for 4–5:59 hours due to a Controllable Irregularity are entitled to a Voucher good for future travel on JetBlue in the amount paid by the customer for the oneway trip.
- Customers whose flight is delayed prior to scheduled departure for 6 or more hours due to a Controllable Irregularity are entitled to a Voucher good for future travel on JetBlue in the amount paid by the customer for the roundtrip (or the oneway trip, doubled).

OVERBOOKINGS
(As defined in JetBlue's Contract of Carriage)
Customers who are involuntarily denied boarding shall receive $1,000.

ONBOARD GROUND DELAYS
For customers who experience an onboard Ground Delay for more than 5 hours, JetBlue will take necessary action so that customers may deplane. JetBlue will also provide customers experiencing an onboard Ground Delay with food and drink, access to restrooms and, as necessary, medical treatment.

Arrivals:

- Customers who experience an onboard Ground Delay on Arrival for 30–59 minutes after scheduled arrival time are entitled to a $25 Voucher good for future travel on JetBlue.
- Customers who experience an onboard Ground Delay on Arrival for 1–1:59 hours after scheduled arrival time are entitled to a $100 Voucher good for future travel on JetBlue.
- Customers who experience an onboard Ground Delay on Arrival for 2–2:59 hours after scheduled arrival time are entitled to a Voucher good for future travel on JetBlue in the amount paid by the customer for the oneway trip, or $100, whichever is greater.
- Customers who experience an onboard Ground Delay on Arrival for 3 or more hours after scheduled arrival time are entitled to a Voucher good for future travel on JetBlue in the amount paid by the customer for the roundtrip (or the oneway trip, doubled).

Departures:

- Customers who experience an onboard Ground Delay on Departure for 3–3:59 hours are entitled to a $100 Voucher good for future travel on JetBlue.
- Customers who experience an onboard Ground Delay on Departure for 4 or more hours are entitled to a Voucher good for future travel on JetBlue in the amount paid by the customer for the roundtrip (or the oneway trip, doubled).

SOURCE: *www.jetblue.com, accessed 2007.*

Rising fuel costs were also a major concern for JetBlue in the future, as were potentially increasing operational expenses as the airline's fleet aged and operations expanded. Analysts also thought that JetBlue's growth would dilute the close-knit culture that the company enjoyed in its initial years. However, many industry experts still believed that the airline would be able to overcome most of the hurdles it faced and enjoy significant growth in the future.

NOTES

1. Eryn Brown, "A Smokeless Herb JetBlue Founder David Neeleman . . .," *Fortune*, May 28, 2001.
2. Chris Zappone, "JetBlue Struggles with 'Growing Pains,'" money.cnn.com, April 20, 2007.
3. The Federal Aviation Administration is an agency of the United States Department of Transportation with the authority to regulate and oversee all aspects of civil aviation in the United States.
4. Southwest Airlines, set up by Herb Kelleher in 1978, was the pioneer of low-cost airlines in the United States. The airline was headquartered in Dallas, Texas, and was known for its profitability record (it had posted profits for the 34th consecutive year in January 2007).
5. Eryn Brown, "A Smokeless Herb JetBlue Founder David Neeleman . . .," *Fortune*, May 28, 2001.
6. Airbus Industrie is a leading manufacturer of aircraft in the world. It was established in 1970 and is headquartered in France.
7. Boeing is a U.S.-based manufacturer of aircraft. Boeing and Airbus are the two biggest aviation companies in the world.
8. Flights operating between 9:00 p.m. and 5:00 a.m. local time are called red-eye flights. In North America, red-eye flights fly from the west to the east coast, capitalizing on the time-zone changes.
9. Amy Tsao, "Thinking of Taking Off with JetBlue?" *Business Week*, April 5, 2002.
10. The percentage of accomplished flights in relation to scheduled flight. In other words, it is the percentage of scheduled flights that were not canceled.
11. Paul C. Judge, "How Will Your Company Adapt?" *Fast Company*, November 2001.
12. "Big Airlines Benefit from Bailout Bill," www.taxpayer.net, June 7, 2002.
13. Paul C. Judge, "How Will Your Company Adapt?" *Fast Company*, November 2001.
14. Amy Tsao, "Thinking of Taking Off with JetBlue?" *Business Week*, April 5, 2002.
15. "JetBlue IPO Soars," money.cnn.com, April 12, 2002.
16. "JetBlue Closes Live TV Acquisition," *Communications Today*, September 30, 2002.
17. An airline industry metric arrived at by dividing operating expenses by available seat miles.
18. JetBlue Airways Annual Report 2002.
19. Embraer, a Brazil-based aircraft manufacturer, specialized in manufacturing regional jets.
20. Michael Bobelian, "JetBlue Lands Expansion Plans," *Forbes*, June 10, 2003.
21. JetBlue Airways Annual Report 2003.
22. JetBlue Airways Annual Report 2003.
23. JetBlue Airways Annual Report 2004.
24. "JetBlue Stays in Black," money.cnn.com, January 27, 2005.
25. JetBlue Airways Annual Report 2004.
26. JetBlue Airways Annual Report 2005.
27. JetBlue Airways Annual Report, 2005.
28. Chapter 11 is a chapter of the United States Bankruptcy Code, which permits reorganization under the bankruptcy laws of the United States. Chapter 11 bankruptcy is available to any business, whether organized as a corporation or sole proprietorship, or individual with unsecured debts of at least $336,900.00 or secured debts of at least $1,010,650.00, although it is most prominently used by corporate entities. (www.wikipedia.org)
29. Chris Isidore, "Low Fare Blues," money.cnn.com, November 24, 2004.
30. Press release on www.jetblue.com, November 13, 2003.
31. People Express had revolutionized air travel with its low fares, customer focus, and energetic staff. Within five years, the airline had reached one billion dollars in sales. However, People Express' troubles started in 1985 after it acquired several airlines in the United States, while facing aggressive competition from the FSAs. It was eventually merged with Continental in 1987. The case of People Express was often cited by airline industry analysts as an example of an airline growing too fast and not being able to sustain the growth.
32. The percentage of an aircraft seating capacity that is actually utilized.
33. The average amount one passenger pays to fly one mile.
34. JetBlue Airways Annual Report 2006.
35. JetBlue Airways Annual Report 2006.
36. www.airlinepilotforums.com
37. Grace Wong, "JetBlue Fiasco: $30M price tag," money.cnn.com, February 20 2007.
38. In 2006, the complaint rate was only 0.4 complaints per 100,000 passengers, which was the third best in the industry, behind Southwest, and a feeder airline for Continental Express called ExpressJet (Source: "JetBlue Fliers Stranded on Plane for 8 hours," *Fortune*, February 15 2007.)
39. The airline featured consistently in the University of Nebraska's national Airline Quality Rating (AQR) study every year since 2003; it ranked first in 2004, 2005, and 2006. It won the Readers' Choice Award from Condé Nast Traveler for five years until 2006, and ranked high in every measured category in the airline satisfaction ratings study conducted by J.D. Power & Associates.

40. "An Extraordinary Stumble at JetBlue," *Business Week*, March 5, 2007.

41. Crisis Management International was an Atlanta-based global consulting firm that specialized in helping organizations prepare for and manage the unexpected by offering strategic crisis management planning and related consulting services.

42. Chuck Salter, "Lessons from the Tarmac," *Fast Company*, May 2007.

43. Under the alliance, passengers could use their frequent flier miles on both the airlines.

44. Jessica Dickler, "Delays Thwart Virgin America's First Flight," money.cnn.com, August 8, 2007.

CASE 21

TomTom: New Competition Everywhere!

Alan N. Hoffman

TOMTOM WAS ONE OF THE LARGEST PRODUCERS OF SATELLITE NAVIGATION SYSTEMS IN THE WORLD. Its products were comprised of both stand-alone devices and applications. TomTom led the navigation systems market in Europe and was second in the United States. TomTom attributed its position as a market leader to the following factors: the size of its customer and technology base, its distribution power, and its prominent brand image and recognition.[1]

With the acquisition of Tele Atlas, TomTom became vertically integrated and also controlled the map creation process. This helped TomTom establish itself as an integrated content, service, and technology business. The company was Dutch by origin and had its headquarters based in Amsterdam, The Netherlands. In terms of geography, the company's operations spanned from Europe to Asia Pacific, covering North America, the Middle East, and Africa.[2]

TomTom was supported by a workforce of 3,300 employees from 40 countries. The diverse workforce enabled the company to compete in international markets.[3] The company's revenues had grown from €8 million in 2002 to €1.674 billion in 2008. (See **Exhibits 1 and 2.**)

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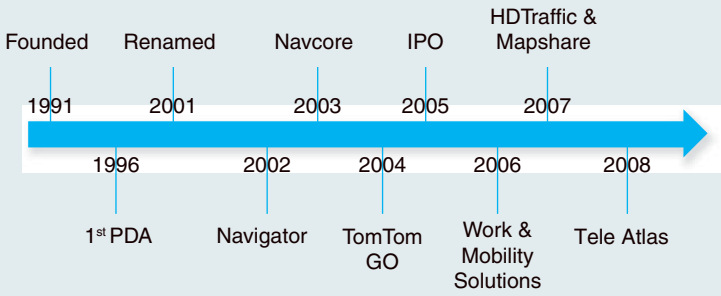
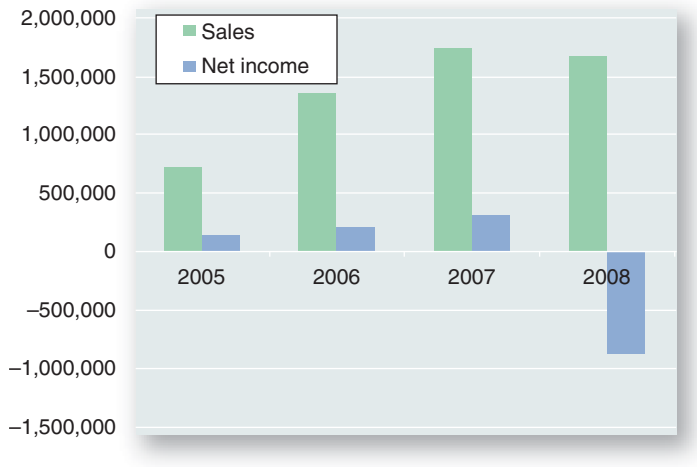
EXHIBIT 1
Company History: TomTom



Year	Historical Event
1991	Palmtop founded by Harold Goddijn, Peter-Frans Pauwels and Pieter Geelen.
1994	Corinne Vigreux joined the Company to sell Palmtop applications in Europe.
1996	First navigation software for PDAs, EnRoute and RouteFinder launched.
2001	Palmtop renamed TomTom. Harold Goddijn joins TomTom as CEO. Number of employees 30.
2002	First GPS-linked car navigation product for PDAs, TomTom NAVIGATOR shipped. €8 million revenue.
2003	NavCore Software Architecture developed, on which all TomTom products are still based. Number of employees 90.
2004	First portable navigation device shipped, the TomTom GO. 248,000 PND units sold.
2005	TomTom listed on Euronext Amsterdam. €720 million revenue.
2006	TomTom WORK and TomTom Mobility Solutions launched. Number of employees 818.
2007	TomTom makes offer for Tele Atlas. TomTom HD Traffic and TomTom Map Share launched. 9.6 million PND units sold.
2008	TomTom acquired Tele Atlas.

SOURCE: *http://investors.tomtom.com/overview.cfm*

EXHIBIT 2
Sales Revenue and Net Income (€): TomTom (Dollar amount in millions of €)



However, because of the Tele Atlas acquisition and the current economic downturn, the company has recently become a cause of concern for investors. On July 22, 2009, TomTom reported a fall of 61% in its net income at the end of the second quarter of 2009.[4] TomTom was in the business of navigation-based information services and devices. The company had been investing structurally and strategically in research and development to bring new and better

products and services to its customers. The company's belief in radical innovation helped it remain at the cutting edge of innovation within the navigation industry.

The vision of TomTom's management was to improve people's lives by transforming navigation from a "don't-get-lost solution" into a true travel companion that gets people from one place to another safer, faster, cheaper, and better informed. This vision helped the company become a market leader in every marketplace in the satellite navigation information services market.[5]

The company's goals focused around radical advances in three key areas:

- **Better maps:** This goal was achieved by maintaining TomTom's high-quality map database, which was continuously kept up-to-date by a large community of active users who provided corrections, verifications, and updates to TomTom. This was supplemented by inputs from TomTom's extensive fleet of surveying vehicles.[6]
- **Better routing:** TomTom had the world's largest historical speed profile database IQ Routes™ facilitated by TomTom HOME, the company's user portal.[7]
- **Better traffic information:** TomTom possessed a unique, real-time traffic information service called TomTom HD traffic™ which provided users with high-quality, real-time traffic updates.[8] These three goals formed the base of satellite navigation, working in conjunction to help TomTom achieve its mission.

TomTom's Products

TomTom offered a wide variety of products ranging from portable navigation devices to software navigation applications and digital maps. The unique features in each of these products made them truly "the smart choice in personal navigation."[9] Some of these products are described below.

TomTom Go and TomTom One

These devices came with a LCD screen that made it easy to use with fingertips while driving. They provided 1,000 Points of Interest (POI) that helped in locating petrol stations, restaurants, and places of importance. A number of other POIs could also be downloaded. Precise, up-to-the-minute traffic information, jam alerts, and road condition alerts were provided by both these devices.[10]

TomTom Rider

These were portable models especially designed for bikers. The equipment consisted of an integrated GPS receiver that can be mounted on any bike and a wireless headset inside the helmet. Similar to the car Portable Navigation Devices (PNDs), the TomTom Rider models had a number of POI applications. The interfaces used in TomTom Rider were user-friendly and came in a variety of languages.[11]

TomTom Navigator and TomTom Mobile

These applications provided navigation software along with digital maps. Both of these applications were compatible with most mobiles and PDAs provided by companies like Sony, Nokia, Acer, Dell, and HP. These applications came with TomTom HOME, which could be used to upgrade to the most recent digital maps and application versions.[12]

TomTom for iPhone

On August 17, 2009, TomTom released TomTom for the iPhone. "With TomTom for iPhone, millions of iPhone users can now benefit from the same easy-to-use and intuitive interface, turn-by-turn spoken navigation and unique routing technology that our 30 million portable navigation device users rely on every day," said Corinne Vigreux, Managing Director of TomTom. "As the world's leading provider of navigation solutions and digital maps, TomTom was the most natural fit for an advanced navigation application on the iPhone."[13]

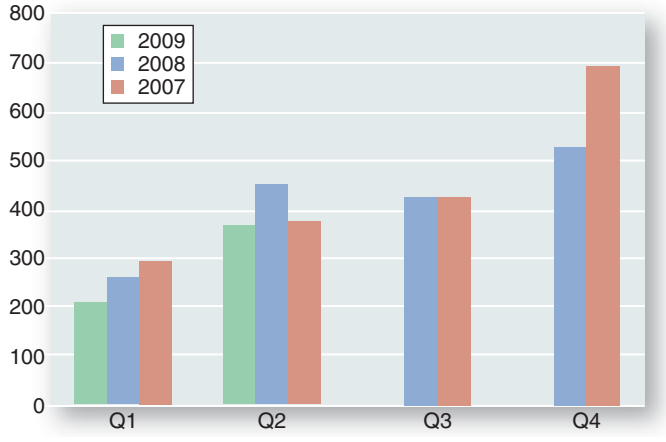
The TomTom app for iPhone 3G and 3GS users included a map of the United States and Canada from Tele Atlas, and was available for $99.99 USD.

The TomTom app for iPhone included the exclusive IQ Routes™ technology. Instead of using travel time assumptions, IQ Routes based its routes on the actual experience of millions of TomTom drivers to calculate the fastest route and generate the most accurate arrival times in the industry. TomTom IQ Routes empowered drivers to reach their destination faster up to 35% of the time.

Company History

TomTom was founded as "Palmtop" in 1991 by Peter-Frans Pauwels and Pieter Geelen, two graduates from Amsterdam University, The Netherlands. Palmtop started out as a software development company and was involved in producing software for handheld computers, one of the most popular devices of the 1990s. In the following few years, the company diversified into producing commercial applications including software for personal finance, games, a dictionary, and maps. In the year 1996, Corinne Vigreux joined Palmtop as the third partner. In the same year, the company announced the launch of Enroute and RouteFinder, the first navigation software titles. As more and more people using PCs adopted Microsoft's operating system, the company developed applications which were compatible with it. This helped the company increase its market share. In 2001, the turning point in the history of TomTom, Harold Goddijn, the former Chief Executive of Psion, joined the company as the fourth partner. Not only did Palmtop get renamed to TomTom, but it also entered the satellite navigation market. TomTom launched TomTom Navigator, the first mobile car satnav system. Since then, as can be seen in **Exhibit 3**, the company has celebrated the successful launch of at least a product each year.[14]

EXHIBIT 3
Quarterly Sales: TomTom (Dollar amount in millions €)



In 2002, the company generated revenue of €8 million by selling the first GPS-linked car navigator, the TomTom Navigator, for PDAs. The upgraded version, Navigator 2, was released in early 2003. Meanwhile, the company made efforts to gain technical and marketing personnel. TomTom took strategic steps to grow its sales. The former CTO of Psion, Mark Gretton, led the hardware team while Alexander Ribbink, a former top marketing official, looked after sales of new products introduced by the company.

TomTom Go, an all-in-one car navigation system, was the company's next major launch. With its useful and easy-to-use features, TomTom Go was included in the list of successful products of 2004. In the same year, the company launched TomTom Mobile, a navigation system which sat on top of Smartphones.[15]

TomTom completed its IPO on the Amsterdam Stock Exchange in May 2005, raising €469 million ($587 million). The net worth of the company was nearly €2 billion after the IPO. A majority of the shares were held by the four partners.[16] From the years 2006 to 2008, TomTom strengthened itself by making three key strategic acquisitions. Datafactory AG was acquired to power TomTom WORK through WEBfleet technology, while Applied Generics gave its technology for Mobility Solutions Services. However, the most prominent of these three was the acquisition of Tele Atlas.[17]

In July of 2007, TomTom bid for Tele Atlas, a company specializing in digital maps. The original bid price of €2 billion was countered by a €2.3 billion offer from Garmin, TomTom's biggest rival. When TomTom raised its bid price to €2.9 billion, the two companies initiated a bidding war for Tele Atlas. Although there was speculation that Garmin would further increase its bid price, in the end management decided not to pursue Tele Atlas any further. Rather, Garmin struck a content agreement with Navteq. TomTom's shareholders approved the takeover in December 2007.[18]

TomTom's Customers

TomTom was a company that had a wide array of customers, each with their own individual needs and desires. TomTom had a variety of products to meet the requirements of a large and varied customer base. As an example, its navigational products ranged from $100–$500 in the United States, ranging from lower-end products with fewer capabilities to high-end products with advanced features.

The *first* group was the individual consumers who bought stand-alone portable navigation devices and services. The *second* group was automobile manufacturers. TomTom teamed with companies such as Renault to develop built-in navigational units to install as an option in cars. A *third* group of customers was the aviation industry and pilots with personal planes. TomTom produced navigational devices for air travel at affordable prices. A *fourth* group of customers was business enterprises. Business enterprises referred to companies such as Wal-Mart, Target, or Home Depot; huge companies with large mobile workforces. To focus on these customers, TomTom formed a strategic partnership with a technology company called Advanced Integrated Solutions to "optimize business fleet organization and itinerary planning on the TomTom pro series of navigation devices." This new advanced feature on PNDs offered ways for fleet managers and route dispatchers to organize, plan, and optimize routes and to provide detailed mapping information about the final destination. "Every day, companies with mobile workforces are challenged to direct all their people to all the places they need to go. Our customers appreciate having a central web repository to hold and manage all their location and address information,[19] said Scott Wyatt, CEO of Advanced Integrated Solutions. TomTom's *fifth* group of customers, the Coast Guard, was able to use TomTom's marine navigational devices for its everyday responsibilities.

Mergers and Acquisitions

TomTom made various mergers and acquisitions as well as partnerships which positioned the company well. In 2008, TomTom acquired a digital mapping company called Tele Atlas. The acquisition significantly improved TomTom customers' user experience and created other benefits for the customers and partners of both companies, including more accurate navigation information, improved coverage, and new enhanced features such as map updates and IQ Routes, which will be discussed in the Resources and Capabilities section of the case. Commenting on the proposed offer, Alain De Taeye, Co-founder and CEO of Tele Atlas, said:

> *". . . the TomTom-Tele Atlas partnership signals a new era in the digital mapping industry. The combination of TomTom's customer feedback tools and Tele Atlas' pioneering map production processes allows Tele Atlas to dramatically change the way digital maps are continuously updated and enhanced. The result will be a completely new level of quality, content and innovation that helps our partners deliver the best navigation products. This transaction is not only very attractive to our shareholders but demonstrates our longstanding commitment towards all of our partners and customers to deliver the best digital map products available."*[20]

In addition to its partnership with Advanced Integrated Solutions, TomTom partnered with Avis in 2005, adding its user-friendly navigation system to all Avis rental cars. This partnership began in Europe, and recently the devices had made their way into Avis rental cars in North America as well as many other countries where Avis operated. Harold Goddijn, Chief Executive Officer of TomTom, commented:

> *"Any traveler can relate to the stress of arriving in a new and unfamiliar city and getting horribly lost. With the availability of the TomTom GO 700 we're bringing unbeatable, full feature car navigation straight into the hands of Avis customers."*[21]

TomTom acquired several patents for its many different technologies. By having these patents for each of its ideas, the company protected itself against its competition and other companies trying to enter into the market.

TomTom prided itself on being the industry innovator and always being a step ahead of the competition in terms of its technology. On the company's website it said, "TomTom leads the navigation industry with the technological evolution of navigation products from static 'find-your-destination' devices into products and services that provide connected, dynamic 'find-the-optimal-route-to-your-destination', with time-accurate travel information. We are well positioned to maintain that leading position over the long-term because of the size of our customer and technology base, our distribution power, and our prominent brand image and recognition. By being vertically integrated and also controlling the map creation process TomTom is in a unique position to evolve into an integrated content, service and technology business."[22]

TomTom had a strong brand name/image. TomTom positioned itself well throughout the world as a leader in portable navigation devices. The company marketed its products through its very user-friendly online website and also through large companies such as Best Buy and Wal-Mart. TomTom also teamed up with Locutio Voice Technologies and Twentieth Century Fox Licensing & Merchandising to bring the original voice of Homer Simpson to all TomTom devices via download. "Let Homer Simpson be your TomTom co-pilot" was one of the many interesting ways TomTom marketed its products and its name to its consumers.[23]

TomTom's Resources and Capabilities

The company believed that there were three fundamental requirements to a navigation system—digital mapping, routing technology, and dynamic information. Based on these requirements, three key resources could be identified that really distinguished TomTom from its competition.

The first of these resources was the in-house **routing algorithms**. These algorithms enabled TomTom to introduce technologies like IQ Routes that provided a "community based information database." IQ Routes calculated customer routes based on the real average speeds measured on roads at that particular time. TomTom's website said, "The smartest route hour-by-hour, day-by-day, saving you time, money and fuel."[24]

The second unique resource was Tele Atlas and the **digital mapping technology** that the TomTom group specialized in. Having the technology and knowledge in mapping that the company brought to TomTom allowed it to introduce many unique features to its customers. First, TomTom came out with a map update feature. The company recognized that roads around the world were constantly changing and, because of this, it used the technology to come out with four new maps each year, one per business quarter. This allowed its customers to always have the latest routes to incorporate into their everyday travel. A second feature it introduced is its Map Share program. The idea behind this is that customers of TomTom who notice mistakes in a certain map are able to go in and request a change to be made. The change was then verified and checked directly by TomTom and was shared with the rest of the global user community. "One and a half million map corrections have been submitted since the launch of TomTom Map Share™ in the summer of 2007."[25]

The third unique resource was **automotive partnerships** with two companies in particular: Renault and Avis. At the end of 2008, TomTom reached a deal with Renault to install its navigation devices in its cars as an option. An article in *AutoWeek* magazine said the following about the deal: "Renault developed its new low-cost system in partnership with Amsterdam-based technology company TomTom, the European leader in portable navigation systems. The system will be an alternative to the existing satellite navigation devices in Renault's upper-end cars."[26] The catch was the new price of the built-in navigation units. The cost of a navigation device installed in Renault's cars before TomTom was €1,500. Now, with the TomTom system, it cost only €500. As mentioned earlier, TomTom also partnered with Avis in 2005 to offer its navigation devices, specifically the model GO 700, in all Avis rental cars, first starting in Europe and then expanding into other countries where Avis operated.

Traditional Competition

TomTom faced competition from two main companies. The first of these was Garmin, which held 45% of the market share, by far the largest and double TomTom's market share (24%). Garmin was founded in 1989 by Gary Burrell and Min H. Kao. The company was known for its on-the-go directions since its introduction into GPS navigation in 1989. At the end of 2008, Garmin reported annual sales of $3.49 billion. Garmin had competed head-to-head in 2009 with TomTom in trying to acquire Tele Atlas for its mapmaking. Garmin withdrew its bid when it became evident that it was becoming too expensive to own Tele Atlas. Garmin executives made a decision that it was cheaper to work out a long-term deal with its current supplier, Navteq, than to try to buy out a competitor.

The second direct competitor was Magellan, which held 15% of the market share. Magellan was part of a privately held company under the name of MiTac Digital Corporation. Similar to Garmin, Magellan products used Navteq-based maps. Magellan was the creator of Magellan NAV 100, the world's first commercial handheld GPS receiver, which was created in 1989. The company was also well-known for its award-winning RoadMate and Maestro series portable car navigation systems.

Together these three dominant players accounted for about 85% of the total market. Other competitors in the personal navigation device market were Navigon, Nextar, and Nokia. Navigon and Nextar competed in the personal navigation devices with TomTom, Magellan, and

Garmin, who were the top three in the industry. But Navigon competed in the high-end segment which retailed for more than any of the competitors but offered a few extra features in its PNDs. Nextar competed in the low-end market and its strategy was low cost. Finally, Nokia was mentioned as a competitor in this industry because the company acquired Navteq, a major supplier of map services in this industry. Along with that, Nokia had a big market share in the cell phone industry and planned on incorporating GPS technology in every phone, making it a potential key player to look for in the GPS navigation industry.

New Competition Everywhere!

Cell Phones

Cell phones were widely used by people all around the world. With the 2005 FCC mandate that required the location of any cell phone used to call 911 to be tracked, phone manufacturers included a GPS receiver in almost every cell phone. Due to this mandate, cell phone manufacturers and cellular services were able to offer GPS navigation services through the cell phone for a fee.

AT&T Navigator

GPS Navigation with AT&T Navigator and AT&T Navigator Global Edition feature real-time GPS-enabled turn-by-turn navigation on AT&T mobile Smartphones (iPhone and Blackberry) or static navigation and Local Search on a non-GPS AT&T mobile Smartphone.

AT&T Navigator featured Global GPS turn-by-turn navigation—Mapping and Point of AT&T Interest content for three continents, including North America (United States, Canada, and Mexico), Western Europe, and China, where wireless coverage was available from AT&T or its roaming providers. The AT&T Navigator was sold as a subscription service and cost $9.99 per month.

Online Navigation Applications

Online navigation websites that were still popular among many users for driving directions and maps were MapQuest, Google Maps, and Yahoo Maps. Users were able to use these free sites to get detailed directions on how to get to their next destination. In the current economic downturn, many people were looking for cheap, or if possible free, solutions to solve their problems. These online websites offered the use of free mapping and navigation information that will allow them to get what they needed at no additional cost. However, there were downsides to these programs: they were not portable and may have poor visualization designs (such as vague image, or text-based).[27]

Built-In Car Navigation Devices

In-car navigation devices first came about in luxury, high-end vehicles. Currently, it had become more mainstream and was now being offered in mid- to lower-tier vehicles. These built-in car navigation devices offered similar features to the personal navigation device but didn't have the portability, so users wouldn't have to carry multiple devices. However, it

came with a hefty price. Some examples of these are Kenwood, Pioneer, and Eclipse units, which are all installed in cars. These units tended to be expensive and overpriced because they were brand name products and required physical installation. For example, the top of the line Pioneer unit was $1,000 for the monitor and another $500 for the navigation device plus the physical labor. When buying such products, a customer spent a huge amount of money on a product that was almost identical to a product TomTom offered at a significantly lower price.

Physical Maps

Physical maps were the primary option for navigating for decades until technology improved them. Physical maps provided detailed road information to help a person get from point A to point B. Although more cumbersome to use than some of the modern technology alternatives, it was an alternative for people who were not technically savvy or for whom a navigation device was an unnecessary luxury.

Potential Adverse Legislation and Restrictions

In the legal and political realm, TomTom had faced two issues that were not critical now, but may have significant ramifications to not only TomTom in the future, but also the entire portable navigation device industry. The reaction of TomTom's management to each of these issues will determine whether or not there was an opportunity for gain or a threat of a significant loss to the company.

The most important issue TomTom dealt with was the possible legislative banning of all navigational devices from automobiles. In Australia, there was growing concern over the distraction caused by PNDs so the legislature took steps toward banning these devices entirely from automobiles.[28] There was a similar sentiment in Ontario, Canada, where a law that was currently under review would ban all PNDs that were not mounted either to the dashboard or to the windshield itself.[29]

With the increase in legislation adding to the restrictions placed on PND devices, the threat that the PND market in the future will be severely limited could not be ignored. All of the companies within the PND industry, not just TomTom, must create a coordinated and united effort to stem this wave of restrictions as well as provide reassurance to the public that they were also concerned with the safe use of their products. This effort can be seen in the heavily regulated toy industry. Many companies within the toy industry had combined to form the International Council of Toy Industries[30] to be proactive in regards to safety regulations, as well as lobby governments against laws that may unfairly threaten the toy industry.[31]

The other issue within the legal and political spectrum that TomTom must focus on was the growing use of GPS devices as tracking devices. Currently, law enforcement agents were allowed to use their own GPS devices to track the movements and locations of individuals they deemed suspicious. However, if budget cuts reduced the access to these GPS devices, then the simple solution will be to use the PND devices already installed in many automobiles.

This issue also required the industry as a whole to proactively work with the consumers and the government to come to an amicable resolution. The threat of having every

consumer's GPS information at the fingertips of either the government or surveillance company will most certainly stunt or even completely halt any growth within the PND industry.

Another alarming trend was the rise in PND thefts around the country.[32] With the prices for PNDs at a relatively high level, thieves were targeting vehicles that had visible docking stations for PNDs either on the dashboard or the windshield. The onus will be on TomTom to create new designs that will not only hide PNDs from would-be thieves but also deter them from trying to steal one. Consumers who were scared to purchase PNDs because of this rise in crime will become an issue if this problem is not resolved.

There was also a current trend, labeled the GREEN movement,[33] that aimed to reduce any activities that will endanger the environment. This movement was a great opportunity for TomTom to tout its technology as the smarter and more environmentally safe tool if driving is an absolute necessity. Not only can individuals tout this improved efficiency, but more importantly on a larger scale, businesses that require large amounts of materials to be transported across long stretches can show activists that they too are working to becoming a green company.

It is ironic that the core technology used in TomTom's navigation system, the GPS system, has proliferated into other electronic devices at such a rapid pace that it has caused serious competition to the PND industry. GPS functionality was a basic requirement for all new Smartphones that entered the market and soon will become a basic functionality in regular cellular phones. TomTom will be hard pressed to compete with these multifunctional devices unless it can improve upon its designs and transform itself into a single focused device.

Another concern for not only TomTom, but also every company that relies heavily on GPS technology, was the aging satellites that supported the GPS system. Analysts predicted that these satellites will be either replaced or fixed before there are any issues, but this issue was unsettling due to the fact that TomTom had no control over it.[34] TomTom will have to devise contingency plans in case of catastrophic failure of the GPS system, much like what happened to Research in Motion when malfunctioning satellites caused disruption in its service.

TomTom was one of the leading companies in the PND markets in both Europe and the United States. Although they were the leader in Europe, that market was showing signs of becoming saturated. Even though the U.S. market was currently growing, TomTom could not wait for the inevitable signs of that market's slowdown as well.

The two main opportunities for TomTom to expand—creating digital maps for developing countries and creating navigational services—can either be piggybacked or can be taken in independent paths. The first-mover advantage for these opportunities will erect a high barrier of entry for any companies that do not have large amounts of resources to invest in the developing country. TomTom was already playing catch-up to Garmin and its already established service in India.

Globalization of any company's products did not come without a certain set of issues. For TomTom, the main threat brought on by foreign countries was twofold. The first threat, which may be an isolated instance, but could also be repeated in many other countries, was the restriction of certain capabilities for all of TomTom's products. Due to security and terrorism concerns, GPS devices have not been allowed in Egypt since 2003.[35] In times of global terrorism, TomTom must be vigilant of the growing trend for countries to become overly protective of foreign companies and their technologies.

Internal Environment

Finance

TomTom's financial goals were to diversify and become a broader revenue-based company. The company not only sought to increase the revenue base in terms of geographical expansion but also wanted to diversify its product and service portfolio. Additionally, another important goal the company strived to achieve was reducing its operating expenses.

Sales Revenue and Net Income

Exhibit 2 shows that from 2005 to 2007 there was a consistent growth in sales revenue as well as a corresponding increase in net income. However, year 2008 was an exception to this trend. In this year sales revenue decreased by 3.7% and the net income decreased by 136%. In fact, in the first quarter the net income was actually negative, totaling –€37 million. The decrease in sales can be accounted for by the downturn in the economy. According to its 2008 annual report, the sales are in line with market expectations. However, the net income plummeted much more than the decrease in sales. This was actually triggered by its acquisition of the digital mapping company—Tele Atlas—which was funded by both cash assets and debt.

Quarterly sales In the second quarter of 2009, TomTom received sales revenue of €368 million compared to €213 million in the first quarter and €453 million in the same quarter in 2008 (**Exhibit 3**). By evaluating quarterly sales for a three-year period from 2007 until the present, it was apparent that the sales followed a seasonal trend in TomTom, with highest sales in the last quarter and lowest in the first quarter. However, focusing on just the first and second quarter for three years, one can infer that the sales revenue as a whole was also going down year after year. To investigate further on the causes of this scenario, the company will have to delve deeper into its revenue base. TomTom's sources of revenue can be broadly grouped into two categories—market segment and geographic location.

Revenue per Segment

TomTom's per segment revenue stream can be divided into PNDs and others, where others consisted of services and content. Evaluating the first quarter of 2008 against that of 2009 and the last quarter of 2008, TomTom experienced steep declines of 40% and 68% (see **Exhibit 4**). This could be a consequence of the compounded effect of the following: (1) The number of devices (PNDs) decreased by a similar amount during both time periods. (2) The average selling price of PNDs had also been decreasing consistently. In a technology company, a decrease in

EXHIBIT 4
Revenue per Segment: TomTom (Dollar amount in million of €)

(in € millions)	Q 1'09	Q 1'08	y.o.y	Q 4'08	q.o.q.
Revenue	172	264	–35%	473	–64%
PNDs	141	234	–40%	444	–68%
Others	31	29	5%	29	5%
# of PNDs sold (in thousands)	1,419	1,997	–29%	4,443	–68%
Average Selling Price (€)	99	117	–15%	100	–1%

average selling price is a part of doing business in a highly competitive and dynamic marketplace. Nevertheless, the revenue stream from business units other than PNDs had seen a steady increase in both the scenarios.

Revenue per Region

TomTom's per region revenue stream can be further divided into Europe, North America, and the rest of the world. Comparing the first quarter of 2009 against 2008, it can be seen that revenue from both Europe and North America were on the decline, with a decrease of 22% and 52%, respectively (see **Exhibit 5**). At the same time, revenue from the rest of the world had seen a huge increase of 90%. Both of these analyses supported TomTom's current goal to increase its revenue base and is aligned with its long-term strategy of being a leader in the navigation industry.

Long-term debt. In 2005, TomTom was a cash-rich company. However, the recent acquisition of Tele Atlas, which amounted to €2.9 billion, was funded by cash, release of new shares, and long-term debt (see **Exhibit 6**), in this case a €1.2 billion loan. These combined to use up TomTom's cash reserves. Currently, TomTom's debt was €1,006 million.

Operating margin. TomTom saw a consistent increase in operating margin until 2006 (see **Exhibit 7**). However, since 2007 operating margin had been decreasing for the firm. In fact, by the end of 2008 it came down to 13% compared to 26% in 2006.

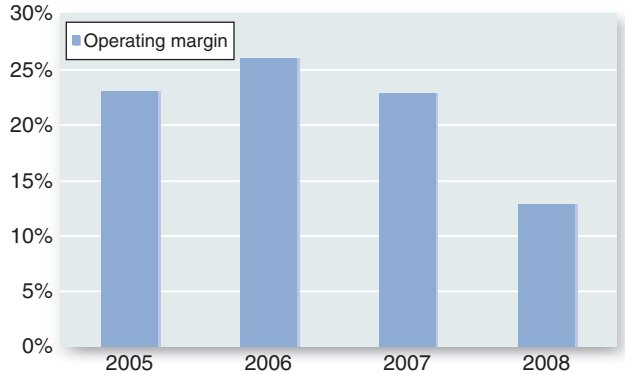
EXHIBIT 5
Revenue per Region: TomTom (Dollar amount in millions of €)

	Quarter 1 of 2009	Quarter 1 of 2009	Difference
Europe	178,114	146,549	–22%
North America	84,641	55,558	–52%
Rest of world	1,087	10,976	90%
Total	263,842	213,083	–24%

EXHIBIT 6
Cash versus Long Term Debt (Dollar amount in thousands of €)

	2005	2006	2007	2008	2009
Long Term Debt	301	338	377	4,749	4,811
Cash Assets	178,377	437,801	463,339	321,039	422,530
Borrowings	0	0	0	1,241,900	1,195,715

EXHIBIT 7
Operating Margin: TomTom



Marketing

Traditionally, high quality and ease of use of solutions have been of utmost importance to TomTom. In a 2006 interview, TomTom's Marketing Head, Anne Louise Hanstad, emphasized the importance of simplicity and ease of use with its devices. This underlined TomTom's belief that people prefer fit for purpose devices that are developed and designed to do one specific thing very well. At that time, both of these were core to TomTom's strategy as its targeted customers were *early adopters.* Now, however, as the navigation industry moved from embryonic to a growth industry, TomTom's current customers were *early majority.* Hence, simplicity and ease alone could no longer provide it with a competitive advantage.

Recently, to be in line with its immediate goal of diversifying into different market segments, TomTom was more focused on strengthening its brand name. In December 2008, TomTom's CEO stated ". . . we are constantly striving to increase awareness of our brand and strengthen our reputation for providing smart, easy-to-use, high-quality portable navigation products and services."[36]

Along with Tele Atlas, the TomTom group has gained depth and breadth of expertise over the last 30 years, which made it a trusted brand. Three out of four people were aware of the TomTom brand across the markets. The TomTom group has always been committed to the three fundamentals of navigation: mapping, routing algorithm, and dynamic information. Tele Atlas' core competency was the digital mapping database and TomTom's was routing algorithms and guidance services using dynamic information. Together, the group created synergies that enabled it to introduce products almost every year advancing on one or a combination of these three elements. Acquiring its long time supplier of digital maps, Tele Atlas, in 2008 gave TomTom an edge with in-house digital mapping technology.

TomTom provided a range of PND devices like TomTom One, TomTom XL, and the TomTom Go Series. Periodically, it tried to enhance those devices with new features and services that were built based on customer feedback. Examples of services were IQ Routes and LIVE services. While IQ Routes provided drivers with the most efficient route planning, accounting for situations as precise as speed bumps and traffic lights, LIVE services formed a range of information services delivered directly to the LIVE devices. The LIVE services bundle included Map Share and HD Traffic, bringing the content collected from vast driving communities directly to the end user.

These products and services accentuated effective designs and unique features, and required TomTom to work with its customers to share precise updates and also get feedback for future improvements. Hence, effective customer interaction became essential to its long-term goal of innovation. In 2008, J. D. Power and Associates recognized TomTom for providing outstanding customer service experience.[37] Although it awarded TomTom for customer service satisfaction, J. D. Power and Associates ranked Garmin highest in overall customer satisfaction. TomTom followed Garmin in the ranking, performing well in the routing, speed of system, and voice direction factors.[38]

As mentioned previously, when the navigation industry was still in its embryonic stages, features, ease of use, and high quality of its solutions gave TomTom products a competitive edge. Eventually, the competition increased in the navigation industry and even substitutes posed a substantial threat to market share. TomTom offered PNDs in different price ranges, broadly classified into high-range and mid-range PNDs, with an average selling price of €99. There were entry-level options that allowed a savvy shopper to put navigation in his/her car for just over $100. Higher-end models added advanced features and services that were previously described.

TomTom sold its PNDs to consumers through retailers and distributors. After acquiring Tele Atlas, it was strategically placed to gain the first mover advantage created by its rapid expansion of geographical coverage.[39] This was of key importance when it came to increasing its global market share.

TomTom directed its marketing expenditure toward B2B advertising that was directed to retailers and distributors. TomTom also invested in an official blog website as well as search optimization, which placed it in premium results in online searches. This enabled TomTom to do effective word-of-mouth promotion while keeping flexible marketing spending, in accordance with changes in the macroeconomic environment or seasonal trends.[40] Although this approach gave TomTom spending flexibility, it lacked a direct B2C approach. In 2009, only 21% of U.S. adults owned PNDs, whereas 65% of U.S. adults neither owned nor used navigation.[41] By not spending on B2C marketing, TomTom discounted on the opportunity both to attract first-tier noncustomers and glean an insight of needs of second-tier noncustomers.[42]

Operations

The focus of operations had always been on innovation. More recently, TomTom's operational objective had been to channel all its resources and core capabilities to create economies of scale so as to be aligned with its long-term strategy. TomTom aimed to focus and centralize R&D resources to create scale economies to continue to lead the industry in terms of innovation.[43]

Implementation of this strategy was well underway and the changes were visible. By the second quarter of 2009, mid-range PNDs were introduced with the capabilities of high-range devices. In addition, 50% of PNDs were sold with IQ Routes technology. The first in-dash product was also launched in alliance with Renault, and the TomTom iPhone application was also announced.[44]

After acquiring Tele Atlas to better support the broader navigation solutions and content and services, the group underwent restructuring. The new organizational structure consisted of four business units that had clear focus on a specific customer group and were supported by two shared development centers.

The four business units were CONSUMER (B2C), composed of retail sales of PND, onboard, and mobile; AUTOMOTIVE (B2B), composed of auto industry sales of integrated solutions and content & services; LICENSING (B2B), composed of PND, automotive, mobile, Internet, and GIS content and services; and WORK (B2B), composed of commercial fleet sales of Webfleet & Connected Solutions.

TomTom's supply chain and distribution model was outsourced. This increased TomTom's ability to scale up or down the supply chain, while limiting capital expenditure risks. At the same time, however, it depended on a limited number of third parties—and in certain instances sole suppliers—for component supply and manufacturing, which increased its dependency on these suppliers.

TomTom's dynamic content sharing model used high-quality digital maps along with the connected services, like HD Traffic, Local Search with Google, and weather information. This provided customers with relevant real-time information at the moment they needed it, which helped them deliver the benefits of innovative technology directly to the end user at affordable prices. Although the network externalities previously mentioned were among the advantages of TomTom's LIVE, it had also increased TomTom's dependency on the network of the connected driving community. The bigger the network, the more effective the information gathered from the guidance services.

Furthermore, in order to reduce operating expenses and strengthen the balance sheet, heavy emphasis had been placed on the cost-cutting program. In 2009, the cost reductions were made up of reduction of staff, restructuring and integration of Tele Atlas, reduced discretionary spending, and reduction in the number of contractors and marketing expenditures. However, if not executed wisely, it could hamper TomTom's long-term objective of being a market leader. For example, one of the core capabilities of any technology company was its staff; reducing it could hinder future innovative projects. This may also occur when reducing the marketing expenditures in a market which still held rich prospects of high growth. Among U.S. adults, 65% did not own any kind of navigation system.[45]

Human Resources

Like in any other technology company the success of individual employees was very important to TomTom. Additionally, TomTom had a vision that company success should also mean success for the individual employee. Therefore, at TomTom, employee competency was taken very seriously and talent development programs were built around it. There was a personal navigation plan that provided employees with a selection of courses based on competencies in their profile. In 2008, TomTom completed its Young Talent Development Program which was aimed at broadening the participants' knowledge, while improving their technical and personal skills.

TomTom's motto was to do business efficiently and profitably, as well as responsibly. This underlined its corporate social responsibility. TomTom's headquarters was one of the most energy efficient buildings in Amsterdam. As previously mentioned, earlier navigation was oriented toward making the drivers arrive at their destination without getting lost. TomTom was the pioneer in introducing different technology that actually helped drivers to make their journeys safer and more economical. This showed TomTom's commitment to its customer base as well as to the community as a whole.

Issues of Concern for TomTom

First, TomTom was facing increasing competition from other platforms using GPS technology, such as cell phones and Smartphones. In the cell phone industry, Nokia was leading the charge in combining cell phone technology with GPS technology. Around the same time TomTom acquired Tele Atlas, Nokia purchased Navteq, a competitor to Tele Atlas. With the acquisition of Navteq, Nokia hoped to shape the cell phone industry by merging cell phone, Internet, and GPS technology.

The Smartphone industry was emerging with the iPhone and the Palm Pre. There was also a shift in how people were able to utilize these technologies as a navigation tool. A big trend in Smartphones were applications. Because of the ease of developing software on platforms for Smartphones, more and more competitors were coming to the forefront and developing GPS navigation applications. On October 28, 2009, Google announced the addition of Tom Tom and Garmin Ltd. as competitors. Google was adding driving directions to its Smartphones.

For TomTom, both of these sectors might signal that major change was on the horizon and that there was no longer a need for hardware for GPS navigation devices. The world seemed to be heading toward a culture where consumers wanted an all-in-one device such as a cell phone or Smartphone that would do everything needed, including offering GPS navigation services. A recent study done by Charles Golvin for Forrester suggested that by 2013 phone-based navigation will dominate the industry. The reason was due to Gen Y and Gen X customers who were increasingly reliant on their mobile phone and who will demand that social networking and other connected services be integrated into their navigation experience.[46]

Secondly, TomTom faced a maturing U.S. and European personal navigation device market. After three years of steady growth in the PND market, TomTom had seen decreasing growth rates for PND sales. Initially entering the European market 12 months before entering the U.S. market, TomTom witnessed a 21% dip in sales for the European market. Although TomTom experienced some growth in the U.S. market for 2008, the growth rate was not as good as in prior years.

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CASE 22

Volcom Inc.: Riding the Wave

Christine B. Buenafe and Joyce P. Vincelette

Introduction

South of Los Angeles, in Velcro Valley, land of the suburban upper-middle class, the top skaters, surfers, and snowboarders set the California fashion trends.[1] Back in the 1990s, one of these individuals carved his path to becoming the CEO of Volcom Inc., a clothing manufacturer, rooted in the action sports of skateboarding, surfing, and snowboarding. Armed with a business degree from Pepperdine University, time spent riding for Quiksilver Inc. as a sponsored surfer, as well as experience in marketing and producing videos for the clothing manufacturer, Richard Woolcott was well prepared to lead his company to its destiny.[2]

By focusing on staying "core" and "respecting the stone," the Volcom family has built a reputation in the Orange County youth apparel industry for authenticity.[3] In 1999, Woolcott said, "Nobody's getting rich. Nobody owns a house. But I know that low tide was in about 45 minutes, and I'm gonna go surfing . . . . I'm living the life that I always dreamed of living."[4] How much more "core" can a CEO get? Volcom has lived quite the life. From the end of fiscal year 2005 to the end of fiscal year 2008, the company's revenues more than doubled from $160 million to $334.3 million. Within the same period, net income ranged between $21.7 and $33.3 million.

As a primary player in the boardsports community, Volcom was committed to maintaining its brand, position, and lifestyle. Creative energy and a rebellious attitude had fueled Volcom for years, but how much more market share can the company garner? How can the company further differentiate itself from its competitors? When the economic downturn of 2008 hit the retail landscape, businesses reevaluated inventories and turned to discounting to

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move products. What does this environment mean for a manufacturer like Volcom? Will the company's strategies effectively influence revenue growth for the long term? Woolcott's team has had plenty of experience in meeting waves, making jumps, and conquering slopes. The company had established a loyal audience and supported talented individuals in living their dreams. What other tricks can Volcom pull to maneuver through this point in the game?

History

Volcom broke onto the retail scene in 1991 in Orange County, California, the epicenter of boardsports culture.[5] Richard "Wooly" Woolcott and Tucker "T-Dawg" Hall came up with the idea to start a clothing company after one fateful snowboarding trip to Lake Tahoe. The two were eager to build a business around their passion for skateboarding, snowboarding, and surfing as well as their love for art, music, and film.

The founders borrowed $5,000 from Woolcott's father to start their company while they surfed and snowboarded on the side.[6] Volcom was headquartered in Woolcott's bedroom in Newport Beach, California, and sales were handled out of Tucker's home in Huntington Beach.[7] The two knew nothing about making clothes but left it all to spirit and creativity.

Volcom's first year sales totaled $2,600. Richard Woolcott told *Transworld Business* magazine that his father called one morning and said, "Son, looking at your numbers, if you don't get your act together, you're going to be out of business in less than three months. I'm not going to help you or bail you out. So you better figure it out."[8] Without any inventory and hardly any money, Woolcott and Tucker decided to take the business more seriously as a step into Volcom's future.

Marketing became a focus for the company as it sought to strengthen the brand and differentiate Volcom within the action sports industry. In 1993, Veeco Production was formed to market Volcom's first video release. In 1995, the company added the Volcom Entertainment division to produce music CDs, and introduced the Volcom Featured Artist Series to showcase the brand's artistic depth. At this time, the company began sponsoring skateboard, snowboard, and surfing athletes and teams as team riders. Stars such as surfer Bruce Irons, skateboarder Geoff Rowley, and Olympic Gold-winning snowboarder Shaun White were contracted to endorse Volcom products.[9] The company further expanded its marketing efforts via launching boardsports competitions, global art tours such as its Hitten Switches book tours, and the Volcomics comic book tour. In early 2001, Volcom contracted with MCA Records to create a new joint venture record label.[10] Other music-related pursuits included sponsoring a stage on the annual Vans Warped Tour, which was popular with the boarding crowd.[11]

Over the years, sales grew dramatically for Volcom, Woolcott's father joined the company's board of directors, and eventually Tucker Hall retired. In 2004, the company recorded a net profit of $24.5 million on revenues of $110.6 million, up 42% from the year before.[12] Menswear was outselling women's by two to one and top customer Pacific Sunwear (PacSun) accounted for 27% of total sales.[13] Volcom products were available in nearly 3,000 stores, representing 1,100 separate clients.[14] Some 85% of sales took place in the United States, with Canada and Japan accounting for most of the rest.[15] The company reincorporated in Delaware in April 2005 and went public in June of the same year. Until then, the company was officially known as Stone Boardwear Inc. Volcom issued 4.19 million shares, which started at $19 and closed at $26.77.[16] In October 2005, the company acquired Welcom Distribution SARL, the distributor of Volcom-branded products in Switzerland.[17]

Volcom Inc. made the No. 11 spot on *BusinessWeek*'s 2006 Hot Growth list of small companies. In that year, the company introduced three new product extensions: Creedler sandals and slip-ons, girl's swimwear, and a boy's clothing line for ages 4 to 7.[18] In anticipating the

expiration of its licensing agreement with its European licensee at the end of fiscal year 2006, the company took direct control of the brand in Europe.[19] The company had been operating there under a licensee model for 10 years. Volcom began delivering product from its newly formed, wholly owned subsidiary constructed in Anglet, France, in the second half of 2007.

Volcom further expanded in 2008. The company entered into an agreement to take direct control of the Volcom brand in the U.K. and acquired the Japanese distributor of Volcom-branded products.[20] Domestically, it acquired the assets of Laguna Surf & Sport, a California-based retail chain operating two retail stores.[21] Furthermore, the company acquired all of the outstanding membership interests of Electric Visual Evolution LLC, or Electric, for $26.3 million plus transaction costs of $1.2 million.[22] Electric was a core action sports lifestyle brand with a well-diversified product line encompassing surf, skate, snow, ski, motocross, and NASCAR.[23]

As of December 31, 2008, Volcom employed 490 full-time European and domestic employees. The company had 13 full-price branded retail stores and licensed eight full-price stores placed in strategic markets around the world. In addition, it owned two multi-brand Laguna Surf & Sport stores. Volcom-branded products were sold throughout the United States and in over 40 countries internationally by Volcom or international licenses supported by in-house sales personnel, independent sales representatives, and distributors.[24] At the end of fiscal year 2008, total revenues amounted to $334.3 million.

Corporate Governance

Board of Directors

The company's seven directors as of December 31, 2008, were:[25]

***Richard R. Woolcott**, 43, founded Volcom in 1991 and has served as Chairman since June 2008 and Chief Executive Officer since Volcom's inception. Mr. Woolcott also served as the Chairman from inception until July 2000 and as President from inception until June 2008. From 1989 until 1991, he worked in the marketing and promotions department of Quiksilver Inc. From 1981 to 1989, he was a sponsored athlete for Quiksilver. Mr. Woolcott was inducted into the National Scholastic Surfing Association Hall of Fame in 2004 and was named the Surf Industry Manufacturers Association Individual Achiever of the Year in 2003. Mr. Woolcott was a member of the National Scholastic Surfing Association National Team from 1982 through 1985 and was selected as a member of the United States Surfing Team in 1984. He earned a BS in Business Administration from Pepperdine University.*

***Douglas S. Ingram**, 46, has served on Volcom's board of directors since June 2005. Mr. Ingram has served as the **Lead Independent Director** since June 2008. Mr. Ingram has been the Executive Vice President, Chief Administrative Officer, General Counsel, and Secretary of Allergan Inc., a NYSE-listed specialty pharmaceutical company, since October 2006. Mr. Ingram received a BS from Arizona State University and a law degree from the University of Arizona.*

***Anthony M. Palma**, 47, has served on the board of directors since June 2005. Mr. Palma served as President and Chief Executive Officer of Easton-Bell Sports, a privately held manufacturer, marketer, and distributor of sports equipment, from April 2006 to March 2008. Mr. Palma earned a BS in Business Administration and Accounting from California State University, Northridge.*

***Joseph B. Tyson**, 47, has served on the board of directors since June 2005. From October 2006 until August 2007, Mr. Tyson was the Chief Operating Officer of The Picerne Group, a privately funded international investment firm.*

***Carl W. Womack**, 57, has served on the board of directors since June 2005. Mr. Womack served as the Senior Vice President and Chief Financial Officer of Pacific Sunwear of California Inc., a NASDAQ-listed*

apparel retailer, from 1994 until his retirement in October 2004. He earned a BS in Business Administration and Accounting from California State University, Northridge.

***René R. Woolcott**, 77, has served on the board of directors since Volcom's inception in 1991 and served as the Chairman from July 2000 to June 2008. From 1985 to the present, Mr. Woolcott has served as Chairman and President of Clarendon House Advisors, Ltd., a privately owned investment company. He holds a BS summa cum laude from New York University and an MBA from Harvard University.*

***Kevin G. Wulff**, 57, has served on the board of directors since June 2005. Mr. Wulff has been the President and Chief Executive Officer of Pony International, LLC since March 2007. Prior to that, he was the President and Chief Executive Officer of American Sporting Goods from March 2005 through February 2007. He worked for Adidas of America and for Nike Inc. from 1993 to 2001 in various senior management positions. Mr. Wulff was Chairman and CEO of the Women's Tennis Association. He holds a BS in Social Science, Business, and Physical Education from the University of Northern Iowa.*

Corporate Officers

In addition to Mr. Richard R. Woolcott, there were four other key corporate officers:[26]

***Douglas P. Collier**, 46, has served as the Chief Financial Officer and Secretary since 1994. He has also served as the Treasurer since April 2005. He earned a BS in Business Administration and an MS in Accounting from San Diego State University.*

***Jason W. Steris**, 38, has served as President since June 2008 and Chief Operating Officer since 1998. From 1995 to 1998, he served as the National Sales Manager and from 1993 to 1995 he served as the company's Southern California Sales Representative.*

***Tom D. Ruiz**, 48, has served as the Vice President of Sales since 1998.*

***Troy C. Eckert**, 36, was the third person to join Volcom and has served as the Vice President of Marketing since January 2001. Prior to January 2001, he held the position of Marketing Director since 1994. Mr. Eckert joined the company in 1991 as the main team rider and as a marketing assistant. In addition to his overall marketing duties, Mr. Eckert was charged with developing Volcom's skateboarding, snowboarding, and surfing teams, the company's special events programs, and co-developing Veeco Productions. He was a world-class surfer and a three-time champion of the H2O Winter Classic combined surf/snow competition.*

The Volcom Concept

The company stated the following as its mission on the Volcom website as well as on its Facebook page:

> *Facets of an empire are vast. An empire was created somehow ingeniously, without paved roads unique to their own trails. Pioneers to be forefathers. Clear thinking in a cloud of stagnant grey confusion. Connections to vectors venting pressures of a pocket stuck in time. It was our opportunity to share our quest with yours in honor of an era unestablished to the present society. Futuristic perhaps, but it does have people coming back for more. So let's log now and reap later, for the furthest forest was glowing a printless picture. . . . The genetic makeup . . . . Volcom Stone.*[27]

The distinctive diamond-shaped "Volcom Stone" logo was developed for use on products with the help of McElroy Designs.[28] According to Woolcott, the stone "represents the buzz from a good skate session or riding a 10-ft. wave at pipe. The stone represents the euphoric state of riding."[29]

The philosophy behind the brand, "**youth against establishment**," captures an energy based on youth culture to support young creative thinking. The people behind the company "consider themselves to be a family of people not willing to accept the suppression of the

established ways. The company was founded during a time when snowboarding and skateboarding were looked down on, when the U.S. was in a recession, there were riots in LA and the Gulf War."[30] According to Volcom, "Nirvana and Pearl Jam expressed it the best."[31]

Volcom may very well be the first major apparel company founded on the boardsports of skateboarding, surfing, and snowboarding.[32] The company's headquarters in Orange County was essential to Volcom's strategy. According to Danny Kwok, Co-President of Quiksilver, "Orange County was to the youth-apparel market what New York was to the fashion world."[33] The Volcom stone logo in Orange County commanded huge respect within the genre of attitude-drenched brands that cool 15-year-olds craved.[34]

Products[35]

Volcom offered six primary product categories under the Volcom brand: mens, girls, boys, footwear, girls' swim, and snow. The company sold T-shirts, fleece, bottoms, tops, jackets, boardshorts, denim, outerwear, and sandals that boasted the fusion of fashion, functionality, and athletic performance. Through the Electric brand, Volcom generated revenues via the company's growing product line, which included sunglasses, goggles, T-shirts, bags, hats, belts, and other accessories. Volcom also generated revenues from the sale of music produced by Volcom Entertainment and films produced by Veeco Productions. Volcom's products typically retailed at premium prices. **Exhibit 1** shows company revenues by product category for the years ended 2005 through 2008.

Clothing Design[36]

Volcom utilized the creativity, innovation, and athlete-driven youth energy behind the brand to design products that evolve in style and functionality. A majority of its clothing products displayed a distinctive art style via unique treatments, placements of screened images, designs, or embroideries. In addition, the company incorporated technical features and fabrics like Gore-Tex® to meet the demands of skateboarding, snowboarding, and surfing.

EXHIBIT 1 Revenues by Product Category: Volcom Inc. (Dollar amount in thousands)

	2008	2007	2006	2005
Boys	21,867	20,023	11,860	7,133
Footwear	5,676	6,127	1,573	–
Girls' swim	6,126	3,734	–	–
Electric	24,190	–	–	–
Other*	3,233	2,667	2,361	1,411
Subtotal product categories	332,110	265,193	201,186	156,716
Licensing revenues	2,194	3,420	4,072	3,235
Total consolidated revenues	$334,304	$268,613	$205,258	$159,951

**Other includes revenues primarily related to the company's Volcom Entertainment division, films, and related accessories.*

SOURCE: *Volcom, Inc., Form 10-K for 2005 (p. F-24) and 2008 (p. F-28).*

Volcom's design and product development teams were based at headquarters in Orange County and in France. Each team was organized into groups that separately focused on each product category. The company designed for five major seasons: spring, summer, fall, snow, and holiday. Volcom's international licensees also hired designers and merchandisers to create products that integrated the brand with local trends. Several times each year, the in-house design team and the designers from the international licensees met to develop designs that reflected fashion trends from around the world. These groups participated in approximately three trips per year to locations known for their influence on fashion and style, such as New York, Paris, London, Sydney, and Tokyo.

Furthermore, the company utilized input from boardsports athletes and relevant artists in product development and design, reinforcing the credibility and authenticity of the brand. Through its V.Co-Operative product line, Volcom partnered with team riders, such as Bruce Irons, Mark Appleyard, Ozzie Wright, Dean Morrwason, Bjorn Leines, Geoff Rowley, and Dustin Dollin, to design signature product styles. Core retail accounts also offered input providing the company with additional insight into consumer preferences.

Music[37]

Volcom generated a mere 1% of revenue each year from 2005 until 2008 for the product category it referred to as "Other," which included revenues generated from Volcom Entertainment, films, and related accessories. The company's music label, Volcom Entertainment, signed musical artists and produced and distributed recordings in the form of CDs, digital downloads, vinyl LPs, and wireless media. Volcom did this worldwide through retail accounts, music retailers, and online distribution channels. The label reinforced the company's brand image and enhanced marketing efforts. The Volcom band played at tradeshows, account demonstrations, and other company events. Music and bands were also integrated into the Volcom brand seasonally via a line of music and musician-inspired clothing.

In 2007, the company launched "The Volcom Tour," an international music tour featuring its artists. Volcom also operated and sponsored an annual music competition, "Band Joust," for unsigned rock bands. In 2008, the company launched a subscription-based vinyl record club, Volcom Ent Vinyl Club, which delivered to subscribers collectable vinyl singles on a bi-monthly basis. The company entered into a distribution arrangement with WEA Rock LLC, pursuant to which ADA, a music distribution company owned by Warner Music Group, distributed its music. The arrangement provided Volcom bands with worldwide distribution options.

Film[38]

The company produced skateboarding, snowboarding, and surfing films featuring sponsored athletes through Veeco Productions, Volcom's film production division. Volcom team riders wore branded products to emphasize the company's boardsports heritage and close association with leading boardsports athletes. The division produced over 15 critically acclaimed films that received awards such as Best Core Film at the X-Dance Film Festival, Best Cinematography for a Snow Movie at the Unvailed Band and Board Event, Surfer Magazine's Video of the Year, and Surfer Magazine's Video Award for Best Performance by a Male Surfer (Bruce Irons—twice).

Films were distributed to retail customers, as well as to music and video stores. In 2008, Veeco Productions entered into distribution deals with iTunes and Fuel TV. As of 2008, the company sold four movies on iTunes under Volcom Films and produced and released two movies specifically for Fuel TV.

Manufacturing[39]

In 2006, Volcom was awarded the Surf Industry Manufacturers Association (SIMA) "Manufacturer of the Year" title for the third time. Volcom did not own or operate any manufacturing facilities; rather, the company worked with local sourcing agents aligned with independently owned foreign contract manufacturers. Volcom's apparel and accessories were generally purchased or imported as finished goods; the company purchased only a limited amount of raw materials. The manufacture of each product line was contracted separately based on fabric and design requirements. Instead of pursuing long-term contracts with manufacturers, Volcom chose to retain flexibility in re-evaluating sourcing and manufacturing decisions. Volcom had traditionally received a significant portion of its customer orders prior to placement of its initial manufacturing orders. It used these early season orders, and its experience, to project overall demand for its products to secure manufacturing capacity and to enable its manufacturers to order sufficient raw materials.

The company chose vendors based on the quality of their work, ability to deliver on time, and cost. Commitment to quality control and monitoring procedures were an important and effective means of maintaining the quality of Volcom's products and its reputation among consumers. The company's design and production staff, as well as third parties, formally assessed manufacturers for quality and to ensure that they were in compliance with applicable labor practices.

In 2008, Volcom contracted for manufacturing with approximately 49 foreign firms. An estimated 66% and 14% of total product costs during 2008 and 72% and 13% of total product costs during 2007 came from manufacturing operations in China and Mexico, respectively. Two of Volcom's Chinese manufacturers, Dragon Crowd and Ningbo Jehson Textiles, accounted for 18% and 14% of product costs during 2008, respectively, and for 19% and 14% of product costs during 2007, respectively. No other single manufacturer of finished goods accounted for more than 10% of production expenditures during 2008 or 2007.

Volcom contracted with several screen printers in the United States. Relationships with domestic printers resulted in short lead times and enabled the company to react quickly to reorder demand from retailers and distributors.

Distribution and Sales[40]

The company sold merchandise in an environment that supported and reinforced its elite brand image. Volcom's retail customers were limited to independent surf and skateboard shops and high-end retail chains. Volcom products were offered over the Internet through selected authorized online retailers. In addition, the company sold to distributors in Latin America, Asia Pacific, and other developing markets. Volcom sought to enhance brand image by controlling the distribution of its products around the world. The company website provided a link where customers could report counterfeit and unauthorized Volcom products, or fakes.

Some of Volcom's retailers included 17th Street Surf, Becker Surfboards, Froghouse, Hotline, Huntington Surf & Sport, IG Performance, K5 Board Shop, Macy's, Nordstrom, Pacific Sunwear, Snowboard Connection, Sun Diego, Surfside Sports, Tilly's, Val Surf, West Beach, and Zumiez. In 2008, 2007, and 2006, 28%, 33%, and 44%, respectively, of product revenues were derived from Volcom's five largest customers. The largest of the five, Pacific Sunwear, accounted for 16%, 18%, and 26% of the company's product revenues in 2008, 2007, and 2006, respectively.

Retailers represented the foundation of the boardsports market and were therefore a critical element to Volcom's success. Specialty retailers attracted skateboarders, snowboarders, and surfers who influenced fashion trends and demand for boardsports products. Volcom

collaborated with specialty retailers by providing in-store marketing displays, which included racks, wall units, and point-of-purchase materials that promote its brand image. Additionally, Volcom sponsored events and programs at its retailers, such as autograph signings and board-sport demonstrations with team riders.

The company maintained a national sales force of independent sales representatives. For certain larger retail accounts and distributors, Volcom managed the sales relationship in-house. The in-house sales team served major national accounts like Zumiez, Pacific Sunwear, Nordstrom, and Macy's. An in-house sales team also served international territories not represented by Volcom's international licensees, such as Canada, Asia Pacific, and Latin America.

Volcom pre-booked orders in advance of delivery so as to maintain sufficient inventories to meet the demands of its retailers. The company inspected, sorted, packed, and shipped substantially all of its products, other than those sold by its licensees or in Canada, from its distribution warehouse in Orange County for its U.S. operations, and from its warehouse in France for its European operations. Volcom distributed products sold in Canada through a third-party distribution center located in Kamloops, British Columbia.

Volcom used an integrated software package designed for apparel distributors and producers. It was used for stock keeping unit (SKU) management and classification inventory tracking, purchase order management, merchandise distribution, and integrated financial management, among other activities. The system provided summary data for all departments and a daily executive summary report used by management to observe business and financial trends.

Licensing[41]

Volcom had license agreements with four independent licensees in Australia, Brazil, South Africa, and Indonesia. The company had a 13.9% ownership interest in its Australian licensee, Volcom Australia. The expiration dates for its international license agreements are listed in **Exhibit 2**.

Research and Development: The Pipe House[42]

In February 2007, Volcom purchased the Pipe House (one of the most famous houses in surfing history) on the North Shore of Oahu for $4.2 million. It was Volcom's second residence in front of the world-renowned Pipeline surf break. The Pipe House was the headquarters for top Volcom team riders and also served as a research and development center for product design

EXHIBIT 2
International License Agreements: Volcom Inc.

Volcom's international license agreements expire as follows:

Licensee	Expiration Date	Extension Termination Date
Australia	June 30, 2012	N/A
Brazil	December 31, 2013	N/A
South Africa	December 31, 2011	N/A
Indonesia	December 31, 2009	December 31, 2014

SOURCE: *Volcom Inc., 2008 Form 10-K, p.7.*

and testing, as well as retailer roundtables. The original Volcom house accommodated the majority of Volcom's domestic and international up-and-coming team riders and served as a marketing location throughout the year.

Marketing

Volcom management was aware of the possible brand degradation that would come with association with "wannabe" skateboarders, snowboarders, or surfers. The company used its own design team and managed advertising in-house to keep consistent with its heritage, passion for action sports, and the look of its clothing.[43] The company's advertising and promotional strategy consisted of athlete sponsorship, print advertisements, branded events, online marketing, branded retail stores, music, film, and the Featured Artist Series.

Athlete Sponsorship[44]

The company sponsored high-profile skateboarding, snowboarding, surfing, and motocross athletes, in addition to supporting emerging talents to promote and build on the Volcom brand image. Volcom made cash payments to the athletes in exchange for unlimited license for the use of their names and likenesses for various public appearances, magazine exposure, and competitive victories, as well as exclusive association with Volcom apparel. The company also provided limited free products for the athletes' use and paid some travel expenses incurred by sponsored athletes in conjunction with promoting Volcom products. **Exhibit 3** lists Volcom's minimum obligations required to be paid under sponsorship contracts.

Volcom's athletes had won prestigious domestic and international awards. They had participated in a variety of competitions including the X-Games, the Olympics, the Association of Surfing Professionals (ASP) World Championship Tour, and the Motocross des Nations. They had appeared on magazine covers all over the world, and had been featured in video games like EA Sports Skate 2 and Xbox games Amped and Amped 2. As of December 31, 2008, the company's skateboarding athletes included Geoff Rowley, Mark Appleyard, and Rune Gliftberg. Volcom snowboarders included Gigi Rüf, Terje Haakonsen, Bjorn Leines, Kevin Pearce, Janna Meyen, and Elena Hight. Among Volcom's surfers were Bruce Irons, Dean Morrwason, Ozzie Wright, and Dusty Payne. Motocross athletes included Ryan Villopoto and Nico Izzi.

EXHIBIT 3
Schedule of Future Estimated Minimum Payments Required Under Endorsement Agreements: Volcom Inc. (Dollar amount in thousands)

Year Ending December 31	
2009	$ 6,581
2010	4,235
2011	1,730
2012	1,340
2013	800
Thereafter	1,972
	$ 16,658

Note: The amounts listed above are the approximate amounts of the minimum obligations required to be paid under sponsorship contracts. The additional estimated maximum amount that could be paid under the company's existing contracts, assuming that all bonuses, victories, and similar incentives are achieved during the five-year period ending December 31, 2011, is approximately $4.1 million. The actual amounts paid under these agreements may be higher or lower than the amounts discussed above as a result of the variable nature of these obligations.

SOURCE: *Volcom Inc., 2008 Form 10-K, p. F-19.*

Print Advertisements[45]

Volcom placed print advertisements in boardsports magazines like *Thrasher*, *Transworld Skateboarding and Snowboarding*, *Snowboarder*, *Surfing*, and *Surfer*. The company also advertised in fashion lifestyle magazines like *Vice*, *Frank 151*, and *Elle*. The internal art department designed advertisements combining athletes, lifestyle, innovative visual designs, and Volcom's unique style.

Volcom Branded Events[46]

Hundreds of competitors and spectators attended the separate contest series that Volcom ran for skateboarding, snowboarding, and surfing. Volcom had created a global championship event for each series to which the company invited top qualifiers from each event to compete. Volcom's driving philosophy behind its grassroots-branded events was "Let the Kids Ride Free." This philosophy sought to embody the company's anti-establishment brand image. The contests were open on a first-come, first-served basis and entry was free, so amateurs and first-time competitors could compete alongside professionals. Volcom's contests included the Wild in the Parks Skate Series, the Peanut Butter and Rail Jam Snow Series, and the Totally Crustaceous Surf Series.

Volcom relied on its internal marketing department to choose venues and arrange sponsored athlete attendance, marketing, and staffing at each contest. Branded events provided another source of consumer interaction and feedback to help keep the company connected to its audience.

The Website[47]

The company also communicated with its target market via its website, www.volcom.com. Volcom made its collection of apparel and accessories available for viewing online as well as provided links to online retailers and iTunes for access to films and podcasts. The company did not sell apparel on the website but did offer select Volcom Entertainment products.

The website provided news releases, information on team riders, Volcom skate parks, and branded events. In addition, Volcom kept up with the Internet generation through pages on Facebook, Myspace.com, Twitter, and YouTube. Facebook and Myspace friends could connect with other Volcom fans, and consumer affiliation with the company allowed for increased brand awareness. The company updated Twitter followers on events, contests, and its team riders. Videos on YouTube showcased the talent of the Volcom team riders and highlight company contest series.

The Operating Environment

From 2006 to 2007, the U.S. unemployment rate fluctuated between 4.5% and 4.9%.[48] When housing prices began declining in 2006, and defaults and foreclosures on sub-prime mortgages made their impact on the value of mortgage-backed securities in 2007, the resulting credit crunch scared the public into caution and worry.[49] Consumer confidence was low, growth in consumer spending started to slow, and the unemployment rate went in the wrong direction. In April 2008, the U.S. unemployment figure was 5.0%, but increased considerably by 2009.[50] News reports covered a frozen credit market, a global recession, and increased government intervention in the financial markets.

For retailers, this economic environment was like a tumultuous sea with threatening waves. In 2007, companies like Circuit City, KB Toys, Mervyns, Boscov's, Steve & Barry's, and Sharper Image filed for bankruptcy.[51] When the holiday season arrived in 2008, retailers held their breath. Consumers had to shop and spend money for others, and profitability was sure to pick up. According to the International Council of Shopping Centers, however, industry sales fell 2.2% for the holiday shopping season, the biggest decline since at least 1970.[52] In November 2008, chains posted a 2.7% decline in sales. In December, sales dropped 1.7%.[53]

Looking ahead, retail companies were keeping their eyes on pricing and costs in competing within the industry. The business environment looked weak and uncertain considering risks like disruptions to supply chains, currency volatility, natural and man-made disasters, legal liability, and financial market disruption.[54] High energy costs also influenced consumer behavior and the supply chain. Companies had chosen to import products from emerging countries like China due to lower transportation costs and wages. Nevertheless, rising transportation costs and wages in those countries were making companies reconsider their sourcing and diversify their options.[55] In such an environment, retailers were willing to consolidate support functions, and cut underperforming activities, as well as trim payroll. On the other hand, in this buyer's market, these companies had the advantage of negotiating better deals with their suppliers.

Besides maintaining extra cash on the company balance sheet, retailers were tailoring the customer experience to fit their overall image and strategy. Understanding and relating to the target market had to be second nature to the companies. In wooing an audience, retail companies were building their relationships with consumers by catering to niche markets and moving away from mass-marketing. Apparel retailers especially watched over consumers' ever-changing tastes, preferences, and shopping behaviors. The execution of their strategies determined success. As one means of getting to their customers, companies used the Internet to build their brands and establish a following. Besides sharing information and offering entertainment and opportunities to purchase products online, retail companies were competing to flag consumer attention before they clicked someplace else.[56]

Teen shopping behavior and brand preferences were examined in a 2009 survey taken by 1,200 students as well as their parents from 12 cities across the United States. Apparel spending by parents for their teens in Spring 2009 was $915 compared to $1,085 in Fall 2008, but was expected to increase in Fall 2009.[57] West Coast Brands like Pacific Sunwear, Volcom, Quiksilver, and Zumiez took the top spot in clothing brand preferences among teens, followed by Forever 21, Hollwaster, Nike, and American Eagle.[58] Jeff Klinefelter, a senior research analyst, believed the fashion industry in 2009 was in the early stages of a new cycle with traffic and conversion gradually improving as teenage consumers looked to replenish key items in their wardrobes after underspending on the category.[59]

Competitors

Volcom competed with global companies of varying sizes and weights. The company's direct competitors include Quiksilver Inc., including the Roxy and DC brands; Billabong International Limited, including the Billabong and Element brands; as well as Burton and Hurley.[60] The company also competed with smaller companies that focused on one or more boardsport segments.

In examining the broader U.S. Athletic Apparel and Footwear Industry, Volcom faced competitors like Nike Inc., the Adidas Group, Hanes/Champion, and Under Armour.[61] In this broad category, Volcom held market shares of 0.7%, 0.6%, and 0.8% for the years 2008, 2007, and 2006, respectively.[62] Nike Inc. held 8.3%, 8.0%, and 7.9% of the market, respectively.[63] Quiksilver's market share was 2.2%, 2.4%, and 2.6%.[64] Billabong had 1.9%, 1.6%, and 1.7%.[65]

In reference to Volcom's potential growth, Richard Woolcott was quoted in an article for *Time* magazine saying that the core lifestyle was more important to him.[66] He said, "Getting bigger was totally secondary. I don't want to put pressure on what we're doing. I don't even think about getting Quiksilver big."[67]

Quiksilver[68]

In 2008, Quiksilver was the largest apparel company targeting surfers, skaters, and snowboarders, with revenues of $2.26 billion. It sold apparel, footwear, accessories, and related products in over 90 countries with the brands Quiksilver, Roxy, and DC, among others. This California-based company was founded in 1970. Quiksilver's roster of sponsored athletes included Kelly Slater and Tony Hawk. Its sponsored events included Quiksilver's Big Wave Invitational and the Roxy Pro, a popular women's surf event. In November 2008, the company sold Rossignol, a wintersports and golf equipment manufacturer, for $50.8 million, eliminating Quiksilver's risk in hard goods manufacturing and allowing the company to reduce its debt.[69]

Billabong[70]

Billabong was an Australian company that was founded in 1973. It sold apparel, accessories, eyewear, wetsuits, and hard goods in the boardsports sector under brands like Billabong, Element, and Palmers Surf. The company's products were licensed and distributed in more than 100 different countries. In 2008, the company had revenues of $1.35 billion.[71] Billabong promotion and advertising strategies included athlete sponsorships as well as pro surfing tournaments in locations like Australia, South Africa, and Spain.

O'Neill

O'Neill offered surf and snow-related technical products, clothing, footwear, and accessories in 84 countries.[72] The company was founded in California in 1952 by Jack O'Neill, who was credited with the design of neoprene wetsuits for surfers. Jack's son, Pat, was credited with the surfboard leash.[73] In 2007, Logo International BV, a European fashion group, acquired worldwide rights to the O'Neill brand and O'Neill Australia Pty Ltd. Under a separate agreement, the O'Neill family continued to own and operate the O'Neill wetsuit business worldwide, the U.S. outerwear business, and the O'Neill Surf Shops in Santa Cruz, California.[74] O'Neill-sponsored events included the Swatch O'Neill Big Mountain Pro, and the O'Neill Cold Water Classic held in locations like South Africa, Scotland, and Tasmania. The company sponsored team riders in snowboarding, surfing, and wakeboarding.

Burton Snowboards

Burton Snowboards, a private company, was founded in 1977 by Jake Burton Carpenter and was headquartered in Vermont. Besides snowboards, the company's product line encompassed bindings, boots, outerwear, and accessories under the brands Anon Optics, RED, and Gravwas. Carpenter's snowboards were inspired by surfers, the first marketed snowboards. Carpenter campaigned resorts to open their slopes to snowboarders, creating a demand for his product as well as a competitive sport.[75] In 2006, the company extended its target market to include surfers when it bought Channel Islands Surfboards.[76] Burton sponsored athletic events as well as snowboarders like Shaun White and Frederik Kalbermatten.

Hurley[77]

Hurley sold apparel, athletic footwear, equipment, and accessories related to skateboarding and surfing. Besides sponsoring surfers and surf events, the company was also involved in the music industry; it endorsed bands like Blink-182 and Avenged Sevenfold. In 1979, the company began as Hurley Surfboards in California. In 1982, management pursued Billabong and established Billabong USA as a separate entity and licensee for its parent company. When the license agreement was up for renewal in 1995, management returned Billabong USA to its parent company and continued with Hurley. Nike purchased Hurley in 2002 as a strategic move into the action sports industry.

Pacific Sunwear of California Inc.[78]

Pacific Sunwear of California Inc., also known as "Pacific Sunwear" or "PacSun," was a specialty retailer inspired by the youth culture of Southern California. The company was incorporated in 1982 and, as of January 31, 2009, operated 932 stores across the United States and Puerto Rico. PacSun's objective was to be a "Branded House of Brands" that sold casual apparel targeting teens and young adults.[79]

As a percentage of PacSun's total net sales during fiscal 2008, Billabong brands accounted for 11% and Quick brands accounted for 10%. The next largest brand, Fox Racing, accounted for 9% of total net sales that year. The company also offered its own proprietary brands in stores, including Bullhead, Kirra, Kirra Girl, Burt, and Nollie. Sales of these brands accounted for approximately 38% and 30% in fiscal 2008 and 2007, respectively. The company considered its primary competitors to be Abercrombie and Fitch, Hollister, American Eagle Outfitters, Aeropostale, and Urban Outfitters.

Like many other retail stores, PacSun found 2008 to be a difficult year.[80] Net sales decreased 3.9% to $1.25 billion in fiscal 2008 from $1.31 billion in fiscal 2007. PacSun also saw a 6.2% net decrease in gross margin as a percentage of sales. Of that decline, 4.7% was due to increased markdowns and promotional activity associated with the decline in consumer spending and the economic environment, whereas 1.4% was attributed to an increase in occupancy charges as a percentage of net sales in fiscal 2008.

The company expected continued negative same-store results in the short term. To better position itself, PacSun reduced planned inventory levels by at least 20%; reduced planned capital expenditures to not more than $30 million for 2009, a reduction of over $50 million from the fiscal 2008 level; and reduced planned selling, general, and administrative expenses by approximately $35 million versus the fiscal 2008 level.[81] The company also announced a reduction of 11% of its headquarters and field management staff.

Financial Performance[82]

Volcom's consolidated balance sheets and statements of operations for the fiscal years ended 2005 through 2008 are shown in **Exhibits 4** and **5**, respectively.

Even with the economic slowdown of 2008, Volcom's consolidated revenues increased 24.5% to $334.4 million from $268.6 million in 2007. Revenues broken down by operating segment are identified in **Exhibit 6**. Revenues from the European operations increased $32.0 million to $73.0 million primarily as a result of the transition from a licensee model to a direct model during the third quarter of 2007. Consequently, licensing revenues in 2008 decreased 35.8% to $2.2 million. Electric contributed $24.2 million in revenues in 2008; it had been included in Volcom's operating results since January 17, 2008.

EXHIBIT 4

Condensed Consolidated Balance Sheets: Volcom Inc. (unaudited) (Dollar amount in thousands, except share and per share data)

Year Ending December 31	2008	2007	2006	2005
Assets				
Current assets				
Cash & cash equivalents	$79,613	$92,962	$85,414	$71,712
Accounts receivable, gross	67,912	61,053	35,498	22,138
Less: allowances for doubtful accounts	6,998	2,783	1,323	730
Accounts receivable, net	60,914	58,270	34,175	21,408
Inventories				
Finished goods	25,277	19,849	12,959	10,188
Work-in-process	269	214	41	312
Raw materials	1,540	377	185	333
Total inventories	27,086	20,440	13,185	10,833
Prepaid expenses & other current assets	2,596	1,720	1,383	1,366
Income taxes receivable	3,309	326	–	479
Deferred income taxes	4,947	2,956	2,353	1,110
Total current assets	178,465	176,674	136,510	106,908
Property and equipment				
Furniture & fixtures	6,714	3,547	1,869	600
Office equipment	2,666	1,724	1,180	1,062
Computer equipment	6,405	4,959	2,173	1,141
Leasehold improvements	9,608	7,379	1,241	128
Land & building	–	–	2,004	2,004
Buildings	7,215	7,489	–	–
Land	4,723	4,723	–	–
Construction in progress	225	30	5,709	–
Property & equipment, gross	37,556	29,851	14,176	4,935
Less: accumulated depreciation	10,840	5,424	2,649	1,468
Net property & equipment	26,716	24,427	11,527	3,467
Investments in unconsolidated investees	330	298	298	298
Deferred income taxes	4,028	268	660	–
Intangible assets, net	10,578	363	386	451
Goodwill, net	665	–	158	158
Other assets	841	464	209	99
Total assets	$221,623	$202,494	$149,748	$111,381
Liabilities and stockholders' equity				
Current liabilities				
Accounts payable	$15,291	$18,694	$8,764	$5,779
Accrued expenses & other current liabilities				
Payroll & related accruals	5,045	4,000	3,785	1,079
Deferred rent	649	–	–	–
Other accrued expenses & other current liabilities	6,333	6,561	2,390	1,508
Total accrued expenses & other current liabilities	12,027	10,561	6,175	2,587
Income taxes payable	–	–	424	–
Current portion of capital lease obligations	71	72	78	72
Total current liabilities	27,389	29,327	15,441	8,438
Long-term capital lease obligations	23	33	106	183
Other long-term liabilities	414	190	204	–
Income taxes payable, non-current	94	89	–	80
Stockholders' equity				
Common stock	24	24	24	24
Additional paid-in capital	90,456	89,185	86,773	84,418
Retained earnings	101,935	80,226	47,019	18,266
Unrealized loss on foreign currency cash flow hedges, net of tax	(223)	–	–	–
Foreign currency translation adjustment	1,511	–	–	–
Accumulated other comprehensive income (loss)	1,288	3,420	181	(28)
Total stockholders' equity	193,703	172,855	133,997	102,680
Total liabilities and stockholders' equity	$221,623	$202,494	$149,748	$111,381

SOURCE: *Mergent Online: Volcom Company Financials.*

EXHIBIT 5

Statements of Operations: Volcom Inc. (Dollar amounts in thousands, except per share data)

Year Ending December 31	2008	2007	2006	2005
Revenues				
Product revenues	$332,110	$265,193	$201,186	$156,716
Licensing revenues	2,194	3,420	4,072	3,235
Total revenues	334,304	268,613	205,258	159,951
Cost of goods sold	171,208	138,570	103,237	78,632
Gross profit	163,096	130,043	102,021	81,319
Operating expenses				
Selling, general, & administrative expenses	112,464	79,411	58,417	42,939
Asset impairments	16,230	–	–	–
Total operating expenses	128,694	–	–	–
Operating income	34,402	50,632	43,604	38,380
Other income				
Interest income (expense), net	901	3,973	3,833	1,036
Dividend income from cost method investee	–	–	3	11
Foreign currency gain (loss)	(1,807)	401	233	54
Total other income (expense)	(906)	4,374	4,069	1,101
Income before provision for income taxes	33,496	55,006	47,673	39,481
Current income taxes				
Current federal income taxes	12,903	–	–	–
Current state income taxes	3,189	–	–	–
Currnet foreign income taxes	2,004	–	–	–
Total current income taxes (benefit)	18,096	21,882	20,903	11,625
Deferred income taxes				
Deferred federal income taxes	(4,564)			
Deferred state income taxes	(1,181)			
Deferred foreign income taxes	(564)			
Total deferred income taxes (benefit)	(6,309)	(211)	(1,983)	(1,150)
Provision for income taxes	11,787	21,671	18,920	10,475
Income before equity in earnings of investee	–	33,335	28,753	29,006
Equity in earnings of investee	–	–	–	331
Net income	$21,709	$33,335	$28,753	$29,337
Weighted average shares outstanding—basic	24,338	24,303	24,228	21,628
Weghted average shares outstanding—diluted	24,358	24,420	24,305	21,840
Year end shares outstanding	24,374	24,350	24,295	24,214
Net income (loss) per share—basic	$0.89	$1.37	$1.19	$1.36
Net income (loss) per share—diluted	$0.89	$1.37	$1.18	$1.34
Number of full-time employees	490	337	259	181
Number of common stockholders	48	13	36	31

SOURCE: *Mergent Online: Volcom Company Financials.*

EXHIBIT 6
Information Related to the Company's Operating Segments: Volcom Inc. (Dollar amounts in thousands)

	2008	2007	2006
Total revenues			
United States	$237,109	$228,494	$200,735
Europe	73,005	40,119	4,523
Electric	24,190	–	–
Consolidated	$334,304	$268,613	$205,258
Gross profit			
United States	$109,028	$110,412	$100,879
Europe	40,582	19,631	1,142
Electric	13,486	–	–
Consolidated	$163,096	$130,043	$102,021
Operating income (loss)			
United States	$ 33,019	$ 45,790	$ 45,918
Europe	17,470	4,842	(2,314)
Electric	16,087	–	–
Consolidated	$ 66,576	$ 50,632	$ 43,604
Identifiable assets			
United States	$143,776	$187,780	$137,581
Europe	55,997	14,714	12,167
Electric	21,850	–	–
Consolidated	$221,623	$202,494	$149,748

SOURCE: *Volcom Inc., 2008 Form 10-K, p. F-28.*

In 2008, 2007, and 2006, 28%, 33%, and 44%, respectively, of product revenues were derived from Volcom's five largest customers. Pacific Sunwear, a component of the five, accounted for 16% of product revenues in 2008 and 18% in 2007. PacSun purchases were made on a purchase order basis rather than with a long-term contract. Sales to Pacific Sunwear increased 7%, or $3.4 million, for 2008 compared to 2007. Volcom's management expected PacSun revenue to decrease in 2009 as Volcom diversified its account base. Management was assessing strategies to lessen Volcom's concentration with PacSun for it represented a material amount of revenue and could have a significant adverse effect on future operating results.

In 2008, consolidated product revenues increased 25.2% to $332.1 million from $265.2 million in 2007. Volcom experienced revenue growth in each of its product lines. The lines with the strongest growth were girls' swim, snow products, and mens, which increased 64.1%, 26.9%, and 22.0% to $6.1 million, $28.2 million, and $162.3 million, respectively. The company's other lines, boy's products and girls, increased 9.2% and 4.1% to $21.9 million and $80.5 million, respectively.

Exhibit 7 provides revenues by geographic regions for the years ended 2005 through 2008. Revenues in the United States made up the bulk of product revenues with 59.0% and 65.7% or $195.9 million and $174.3 million in 2008 and 2007, respectively. In Europe, product revenues amounted to 23.5% and 15.1% of product revenues, or $77.9 million and $40.1 million in 2008 and 2007, respectively. Product revenues from the rest of the world were primarily the result of sales in Canada and Asia Pacific and did not include sales by Volcom's international licensees. These product revenues were 17.5% and 19.2%, $58.3 million and $50.8 million, in 2008 and 2007, respectively.

For the fiscal year ended December 31, 2008, consolidated operating expenses increased $49.3 million, or 62.1%, to $128.7 million. This increase included the $16.2 million non-cash

EXHIBIT 7
Product Revenues by Geographic Regions: Volcom Inc. (Dollar amount in thousands of dollars)

Includes revenues generated worldwide by the Electric operating segment; allocated based on customer location.

Year Ending December 31

	2008	2007	2006	2005
United States	$195,846	$174,254	$157,581	$128,159
Canada	31,993	31,041	23,925	15,774
Asia Pacific	13,245	8,434	7,230	6,622
Europe	77,897	40,119	4,523	–
Other	13,129	11,345	7,927	6,161
	$332,110	$265,193	$201,186	$156,716

SOURCE: *Volcom, Inc., Form 10-K for 2005 (p. F-25) and 2008 (p. F-29).*

asset impairment charge on goodwill and intangible assets related to the acquisitions of Electric and Laguna Surf & Sport. The estimated future cash flows expected from the reporting units were significantly reduced, causing decreased estimated fair market values as a result of the economic downturn. As a percentage of revenues, selling, general, and administrative expenses increased to 33.6% from 29.6% in 2007. The $33.1 million increase was due primarily to increased expenses of $8.0 million related to the transition of European operations to a direct control model, the $14.7 million expense from the acquisition of Electric, and the $1.0 million expense from the acquisition of Japanese operations. Volcom also increased payroll and payroll-related expenses of $2.6 million due to expenditures on infrastructure and personnel, increased rent expense of $2.1 million from additional retail store leases and the Irvine warehouse location, increased depreciation expense of $1.2 million, increased bad debt expense of $0.9 million, and a net increase of $2.6 million in other expense categories.

As a result of these factors, operating income as a percentage of revenues decreased 10.3% in 2008 from 18.8% in 2007. Consolidated operating income in 2008 decreased $16.2 million to $34.4 million compared to $50.6 million in 2007.

The provision for income taxes was computed using an annual effective tax rate of 35.2%, which decreased from 39.4% in 2007. The decrease was primarily due to the effect of the foreign tax rate differential, which was partially offset by the income tax effect of the goodwill and intangible asset impairment recorded in 2008. The provision for income taxes decreased $9.9 million to $11.8 million in 2008.

In 2008, net income decreased $11.6 million or 34.9% to $21.7 million in 2008. As of the first quarter ended March 31, 2009, Volcom was slightly ahead of expectations in each of its business segments. According to Richard Woolcott, Volcom was "working diligently to maintain (its) competitive edge and position the company to remain financially strong and creatively energized."[83]

NOTES

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CASE 23

TOMS Shoes (Mini Case)

J. David Hunger

Founded in 2006 by Blake Mycoskie, TOMS Shoes was an American footwear company based in Santa Monica, California. Although TOMS Shoes was a for-profit business, its mission was more like that of a not-for-profit organization. The firm's reason for existence was to donate to children in need one new pair of shoes for every pair of shoes sold. Blake Mycoskie referred to it as the company's "One for One" business model.

While vacationing in Argentina during 2006, Mycoskie befriended children who had no shoes to protect them during long walks to obtain food and water, as well as attend school. Going barefoot was a common practice in rural farming regions of developing countries, where many subsistence farmers could not afford even a single pair of shoes. Mycoskie learned that going barefoot could lead to some serious health problems. Podoconiosis was one such disease in which feet and legs swelled, formed ulcers, emitted a foul smell, and caused intense pain. It affected millions of people across 10 countries in tropical Africa, Central America, and northern India. For millions, not wearing shoes could deepen the cycle of poverty and ruin lives. Upset that such a simple need was being unmet, Mycoskie founded TOMS Shoes in order to provide them the shoes they needed. "I was so overwhelmed by the spirit of the South American people, especially those who had so little," Mycoskie said. "I was instantly struck with the desire—the responsibility—to do more." The name of his new venture was TOMS Shoes.

History

Blake Mycoskie started his entrepreneurial career by creating a college laundry service in 1997 when he was a student at Southern Methodist University. In his words, "After we expanded EZ Laundry to four colleges, I sold my share. I moved to Nashville to start an outdoor media company that Clear Channel scooped up three years later." In 2002, Blake and his sister Paige formed a team to compete on the CBS reality show *The Amazing Race*, coming in second. One of the places that they visited during the filming was Argentina. Fascinated by South America,

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Blake returned to Argentina in 2006 for a vacation. "On my visit I saw lots of kids with no shoes who were suffering from injuries to their feet. I decided a business would be the most sustainable way to help, so I founded TOMS, which is short for a 'better tomorrow,'" explained Mycoskie.

While in Argentina, Mycoskie had taken to wearing *alpargatas*—resilient, light-weight, slip-on shoes with a breathable canvas top and soft leather insole traditionally worn by Argentine workers, but worn casually by most people in that country. Mycoskie spent two months meeting with shoe and fabric makers in Argentina. Although he modeled his shoe after the espadrille-like alpargata, he used brighter colors and different materials. "No one looked twice at alpargatas, but I thought they had a really cool style," said Mycoskie. "I'm a fan of Vans, but they can be clunky and sweaty. These aren't. They fit your foot like a glove but are sturdy enough for a hike, the beach, or the city."

Founding his new company that year in Santa Monica, California, the 30-year-old Blake Mycoskie began his third entrepreneurial venture. With a staff of seven full-time employees (including former Trovata clothing line designer John Whitledge), six sales representatives, and eight interns, TOMS Shoes introduced 15 styles of men's and women's shoes plus limited-edition artist versions in June 2006. The shoes were quickly selected for distribution by stores like American Bag and Fred Segal in Los Angeles and Scoop in New York City. By Fall 2006, the company had sold 10,000 pairs of shoes, averaging $38 each, online and through 40 retail stores.

As promised, Mycoskie returned to Argentina in October 2006 with two dozen volunteers to give away 10,000 pairs of shoes along 2,200 miles of countryside. Mycoskie wryly explained what he learned from this experience. "I always thought that I'd spend the first half of my life making money and the second half giving it away. I never thought I could do both at the same time." The next year, TOMS Shoes gave away 50,000 pairs of shoes in "shoe drops" to children in Argentina plus shoe drops to South Africa. More countries were added to the list over the next three years.

Business Model

Realizing that a not-for-profit organization would be heavily dependent upon sponsors and constant fundraising, Mycoskie chose to create an innovative for-profit business model to achieve a charitable purpose. For every pair of shoes that the company sold, it would donate one pair to a child in need. Mycoskie felt that this model would be more economically sustainable than a charity because sales would be used to achieve the company's mission. He saw this to be a form of social entrepreneurship in which a new business venture acted to improve society through product donations at the same time it lived off society through its sales.

Mycoskie believed that the firm's One-for-One model would be self-sustaining because the company could make and sell shoes at a price similar to other shoe companies, but with lower costs. "Selling online (www.toms.com) has allowed us to grow pretty rapidly, but we're not going to make as much as another shoe company, and the margins are definitely lower," he admits. "But what we do helps us to get publicity. Lots of companies give a percentage of their revenue to charity, but we can't find anyone who matches one for one."

Marketing and Distribution

TOMS Shoes kept expenses low by spending only minimally on marketing and promotion. The company's marketing was primarily composed of presentations by Blake Mycoskie, fan word-of-mouth, and promotional events sponsored by the firm. The company won the 2007

People's Design Award at Cooper-Hewitt's National Design Awards. Two years later, Mycoskie and TOMS received the annual ACE award given by U.S. Secretary of State Hillary Clinton. This award recognized companies' commitment to corporate social responsibility, innovation, exemplary practices, and democratic values worldwide. Mycoskie spoke along with President Bill Clinton at the Opening Plenary session of the Second Annual Clinton Global Initiative Conference in 2007. With other business leaders, he also met with President Obama's senior administration in March 2009 to present solutions and ideas to support small businesses. He was also featured in a CNBC segment titled "The Entrepreneurs," in which he and TOMS Shoes was profiled.

Mycoskie explained why he spent so much time speaking to others about TOMS Shoes. "My goal is to inspire the next generation of entrepreneurs and company leaders to think differently about how they incorporate giving into their business models. Plus, many of the people who hear me speak eventually purchase a pair of Toms, share the story with others, or support our campaigns like *One Day Without Shoes*, which has people go barefoot for one day a year to raise awareness about the children we serve."

Celebrities like Olivia Wilde, Karl Lagerfeld, and Scarlett Johansson loved the brand and what it stood for. Actress Demi Moore promoted the 2010 *One Day Without Shoes* campaign on *The Tonight Show with Jay Leno*. It didn't hurt that Mycoskie's fame was supported by his Bill Clinton-like charisma, Hollywood good looks, and his living on a boat in Marina del Rey with "TOMS" sails. Famed designer Ralph Lauren asked Mycoskie to work with him on a few styles for his Rugby collection, the first time Lauren had collaborated with another brand.

TOMS Shoes and Blake Mycoskie were profiled in the *LA Times*, as well as *Inc*., *People*, *Forbes*, *Fortune*, *Fast Company*, and *Time* magazines. Mycoskie pointed out that the 2009 *LA Times* article, "TOMS Shoes the Model: Sell 1, Give 1," resulted in 2,200 orders for shoes in just 12 hours after the article appeared. In February 2010, *FastCompany* listed TOMS Shoes as #6 on its list of "Top Ten Most Innovative Retail Companies."

By early 2007, TOMS Shoes had orders from 300 retail stores, including Nordstrom's, Urban Outfitters, and Bloomingdale's, for 41,000 pairs of shoes from its spring and summer collections. The company introduced a line of children's shoes called Tiny Toms in May 2007 and unveiled a pair of leather shoes in Fall of that year. By September 2010, the company added Whole Foods to its distribution network and had given over 1,000,000 pairs of new shoes to children in need living in more than 20 countries in the Americas (Argentina, El Salvador, Guatemala, Haiti, Honduras, Nicaragua, and Peru), Africa (Burundi, Ethiopia, Lesotho, Malawi, Mali, Niger, Rwanda, South Africa, Swaziland, Uganda, and Zambia), Asia (Cambodia and Mongolia), and Eurasia (Armenia). The shoes were now selling for $45 to $85 a pair.

Operations and Management

TOMS shoes were manufactured in Argentina, China, and Ethiopia. The company required the factories to operate under sound labor conditions, pay fair wages, and follow local labor standards. A code of conduct was signed by all factories. In addition to its production staff routinely visiting the factories to ensure that they were maintaining good working standards, third parties annually audited the factories. The company's original line of alpargata shoes was expanded to include children's shoes, leather shoes, cordones youth shoes, botas, and wedges. In January 2009, the company collaborated with Element Skateboards to create a line of shoes, skate decks, and longboards. For each pair of TOMS Element shoes and/or skateboard bought, one of the same was given to children at the Indigo Skate Camp in the village of Isithumba in Durban, South Africa.

Blake Mycoskie was the company's Chief Executive Officer and joked that he was also its "Chief Shoe Giver." He spent much of his time traveling the country to speak at universities and companies about the TOMS Shoes' business model. According to CEO Mycoskie in a June 2010 article in *Inc.*, "The reason I can travel so much is that I've put together a strong team of about ten people who pretty much lead the company while I am gone. Candice Wolfswinkel is my chief of staff and the keeper of the culture. . . . I have an amazing CFO, Jeff Tyler, and I'll check in with him twice a week. I talk to my sales managers on a weekly basis. I also call my younger brother, Tyler, a lot—he's head of corporate sales." The company had 85 employees plus interns and volunteers. In 2009, more than 1,000 people applied for 15 summer internship positions.

The company depended upon many volunteers to promote the company and to distribute its shoes to needy children. For example, Friends of TOMS was a registered nonprofit affiliate of TOMS Shoes that had been formed to coordinate volunteer activities and all shoe drops. The company sponsored an annual "Vagabond Tour" to reach college campuses. Volunteers were divided into five regional teams to reach campuses throughout the United States to spread information about the One-for-One movement. To capture volunteer enthusiasm, the company formed a network of college representatives at 200 schools to host events, screen a documentary about the brand, or throw shoe decorating parties.

Mycoskie believed that a key to success for his company was his generation's desire to become involved in the world. "This generation is one that thrives off of action. We don't dream about change, we make it happen. We don't imagine a way to incorporate giving into our daily lives—we do it. TOMS has so many young supporters who are passionate about the One for One movement, and who share the story and inspire others every day they wear their TOMS. Seeing them support this business model is proof that this generation is ready and able to create a better tomorrow."

Mission Accomplished: Next Steps?

When Blake Mycoskie originally proposed his One-for-One business model in 2006, few had much confidence in his ability to succeed. He never generated a business plan or asked for outside support. Mycoskie used the money he had earned from his earlier entrepreneurial ventures to fund the new business. Looking back on those days, Mycoskie stated, "A lot of people thought we were crazy. They never thought we could make a profit." Much to everyone's surprise, TOMS Shoes had its first profitable year in 2008, only two years after being founded! The company's sales kept increasing throughout the "great recession" of 2008–2009 and continued being marginally profitable. Mycoskie admitted that the company would have to sell about a million pairs of shoes annually to be really profitable. Nevertheless, TOMS Shoes did not take on any outside investors and did not plan to do so.

In September 2010, Blake Mycoskie celebrated TOMS Shoes' total sales of one million pairs of shoes by returning to Argentina to give away the millionth pair. Looking forward to returning to where it all began, Mycoskie mused: "To reach a milestone like this is really amazing. We have been so busy giving shoes that we don't even think about the scope of what we've created and what we've done."

What should be next for TOMS Shoes? Blake Mycoskie invested a huge amount of his own time, energy, and enthusiasm in the growth and success of TOMS Shoes. Was the company too dependent upon its founder? How should it plan its future growth?

CASE 24

Best Buy Co. Inc.: Sustainable Customer Centricity Model?

Alan N. Hoffman

BEST BUY CO. INC., HEADQUARTERED IN RICHFIELD, MINNESOTA, was a specialty retailer of consumer electronics. It operated over 1,100 stores in the United States, accounting for 19% of the market. With approximately 155,000 employees, it also operated over 2,800 stores in Canada, Mexico, China, and Turkey. The company's subsidiaries included Geek Squad, Magnolia Audio Video, and Pacific Sales. In Canada, Best Buy operated under both the Best Buy and Future Shop labels.

Best Buy's mission was to make technology deliver on its promises to customers. To accomplish this, Best Buy helped customers realize the benefits of technology and technological changes so they could enrich their lives in a variety of ways through connectivity: "To make life fun and easy,"[1] as Best Buy put it. This was what drove the company to continually increase the tools to support customers in the hope of providing end-to-end technology solutions.

As a public company, Best Buy's top objectives were sustained growth and earnings. This was accomplished in part by constantly reviewing its business model to ensure that it was satisfying customer needs and desires as effectively and completely as possible. The company strived to have not only extensive product offerings but also highly trained employees with extensive product knowledge. The company encouraged its employees to go out of their way to help customers understand what these products could do and how customers could get the most out of the products they purchased. Employees recognized that each customer was unique and thus determined the best method to help that customer achieve maximum enjoyment from the product(s) purchased.

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From a strategic standpoint, Best Buy moved from being a discount retailer (a low price strategy) to a service-oriented firm that relied on a differentiation strategy. In 1989, Best Buy changed the compensation structure for sales associates from commission-based to non-commissioned-based, which resulted in consumers having more control over the purchasing process and in cost savings for the company (the number of sales associates was reduced). In 2005, Best Buy took customer service a step further by moving from peddling gadgets to a customer-centric operating model. It was now gearing up for another change to focus on store design and providing products and services in line with customers' desire for constant connectivity.

Company History[2]

From Sound of Music to Best Buy

Best Buy was originally known as Sound of Music. Incorporated in 1966, the company started as a retailer of audio components and expanded to retailing video products in the early 1980s with the introduction of the videocassette recorder to its product line. In 1983, the company changed its name to Best Buy Co. Inc. (Best Buy). Shortly thereafter, Best Buy began operating its existing stores under a "superstore" concept by expanding product offerings and using mass marketing techniques to promote those products.

Best Buy dramatically altered the function of its sales staff in 1989. Previously, the sales staff worked on a commission basis and was more proactive in assisting customers coming into the stores as a result. Since 1989, however, the commission structure has been terminated and sales associates have developed into educators that assist customers in learning about the products offered in the stores. The customer, to a large extent, took charge of the purchasing process. The sales staff's mission was to answer customer questions so that the customers could decide which product(s) fit their needs. This differed greatly from their former mission of simply generating sales.

In 2000, the company launched its online retail store: BestBuy.com. This allowed customers a choice between visiting a physical store and purchasing products online, thus expanding Best Buy's reach among consumers.

Expansion Through Acquisitions

In 2000, Best Buy began a series of acquisitions to expand its offerings and enter international markets:

2000: Best Buy acquired Magnolia Hi-Fi Inc., a high-end retailer of audio and video products and services, which became Magnolia Audio Video in 2004. This acquisition allowed Best Buy access to a set of upscale customers.

2001: Best Buy entered the international market with the acquisition of Future Shop Ltd, a leading consumer electronics retailer in Canada. This helped Best Buy increase revenues, gain market share, and leverage operational expertise. The same year, Best Buy also opened its first Canadian store. In the same year, the company purchased Musicland, a mall-centered music retailer throughout the United States (divested in 2003).

2002: Best Buy acquired Geek Squad, a computer repair service provider, to help develop a technological support system for customers. The retailer began by incorporating in-store Geek Squad centers in its 28 Minnesota stores and expanding nationally and then internationally in subsequent years.

2005: Best Buy opened the first Magnolia Home Theater "store-within-a-store" (located within the Best Buy complex).

2006: Best Buy acquired Pacific Sales Kitchen and Bath Centers Inc. to develop a new customer base: builders and remodelers. The same year, Best Buy also acquired a 75% stake in Jiangsu Five Star Appliance Co., Ltd, a China-based appliance and consumer electronics retailer. This enabled the company to access the Chinese retail market and led to the opening of the first Best Buy China store on January 26, 2007.

2007: Best Buy acquired Speakeasy Inc., a provider of broadband, voice, data, and information technology services, to further its offering of technological solutions for customers.

2008: Through a strategic alliance with the Carphone Warehouse Group, a UK-based provider of mobile phones, accessories, and related services, Best Buy Mobile was developed. After acquiring a 50% share in Best Buy Europe (with 2,414 stores) from the Carphone Warehouse, Best Buy intended to open small-store formats across Europe in 2011.[3] Best Buy also acquired Napster, a digital download provider, through a merger to counter the falling sales of compact discs. The first Best Buy Mexico store was opened.

2009: Best Buy acquired the remaining 25% of Jiangsu Five Star. Best Buy Mobile moved into Canada.

Industry Environment

Industry Overview

Despite the negative impact the financial crisis had on economies worldwide, in 2008 the consumer electronics industry managed to grow to a record high of US$694 billion in sales—a nearly 14% increase over 2007. In years immediately prior, the growth rate was similar: 14% in 2007 and 17% in 2006. This momentum, however, did not last. Sales dropped 2% in 2009, the first decline in 20 years for the electronics giant.

A few product segments, including televisions, gaming, mobile phones, and Blu-ray players, drove sales for the company. Television sales, specifically LCD units, which accounted for 77% of total television sales, were the main driver for Best Buy, as this segment alone accounted for 15% of total industry revenues. The gaming segment continued to be a bright spot for the industry as well, as sales were expected to have tremendous room for growth. Smartphones were another electronics industry segment predicted to have a high growth impact on the entire industry.

The consumer electronics industry had significant potential for expansion into the global marketplace. There were many untapped markets, especially newly developing countries. These markets were experiencing the fastest economic growth while having the lowest ownership rate for gadgets.[4] Despite the recent economic downturn, the future for this industry was optimistic. A consumer electronics analyst for the European Market Research Institute predicted that the largest growth will be seen in China (22%), the Middle East (20%), Russia (20%), and South America (17%).[5]

Barriers to Entry

As globalization spread and use of the Internet grew, barriers to entering the consumer electronics industry were diminished. When the industry was dominated by brick-and-mortar companies, obtaining the large capital resources needed for entry into the market was a barrier for those looking to gain any significant market share. Expanding a business meant purchasing or

leasing large stores that incurred high initial and overhead costs. However, the Internet significantly reduced the capital requirements needed to enter the industry. Companies like Amazon.com and Dell utilized the Internet to their advantage and gained valuable market share.

The shift toward Internet purchasing also negated another once strong barrier to entry: customer loyalty. The trend was that consumers would research products online to determine which one they intended to purchase and then shop around on the Internet for the lowest possible price.

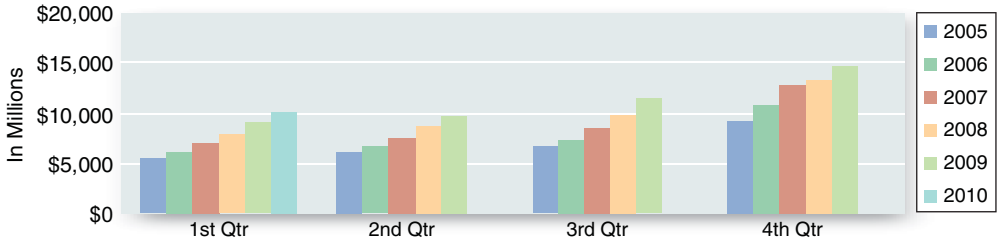
Even though overall barriers were diminished, there were still a few left, which a company like Best Buy used to its advantage. The first, and most significant, was economies of scale. With over 1,000 locations, Best Buy used its scale to obtain cost advantages from suppliers due to high quantity of orders. Another advantage was in advertising. Large firms had the ability to increase advertising budgets to deter new entrants into the market. Smaller companies generally did not have the marketing budgets for massive television campaigns, which were still one of the most effective marketing strategies available to retailers. Although Internet sales were growing, the industry was still dominated by brick-and-mortar stores. Most consumers looking for electronics—especially major electronics—felt a need to actually see their prospective purchases in person. Having the ability to spend heavily on advertising helped increase foot traffic to these stores.

Internal Environment

Finance

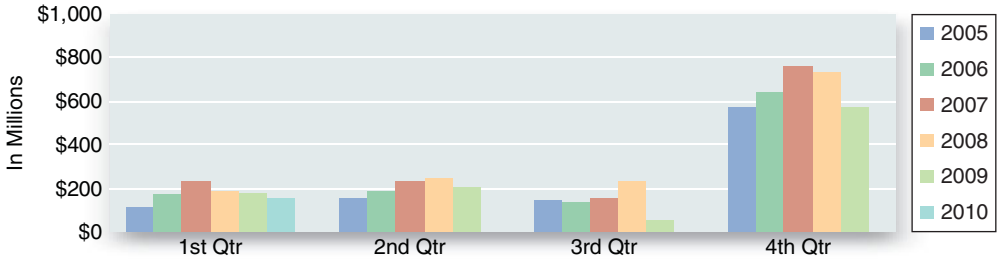
While Best Buy's increase in revenue was encouraging (see **Exhibit 1**), recent growth had been fueled largely by acquisition, especially Best Buy's fiscal year 2009 revenue growth. At the same time, net income and operating margins had been declining (see **Exhibits 2** and **3**). Although this could be a function of increased costs, it was more likely due to pricing pressure. Given the current adverse economic conditions, prices of many consumer electronic products had been forced down by economic and competitive pressures. These lower prices caused margins to decline, negatively affecting net income and operating margins.

EXHIBIT 1
Quarterly Sales, Best Buy Co., Inc.



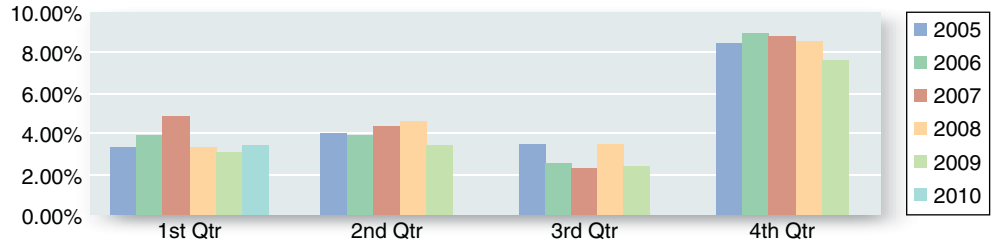
SOURCE: *Best Buy Co., Inc.*

EXHIBIT 2
Quarterly Net Income, Best Buy Co., Inc.



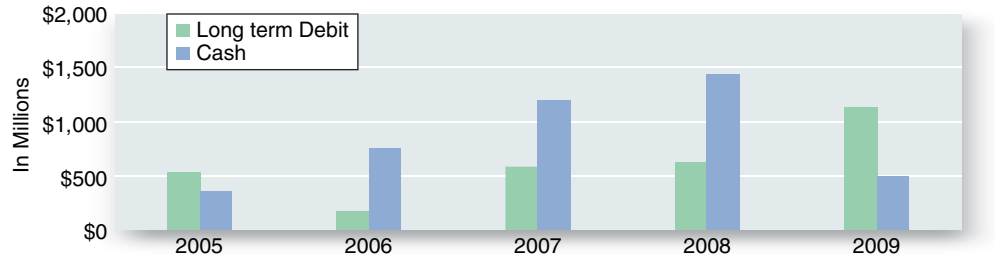
SOURCE: *Best Buy Co., Inc.*

EXHIBIT 3
Operating Margin, Best Buy Co., Inc.



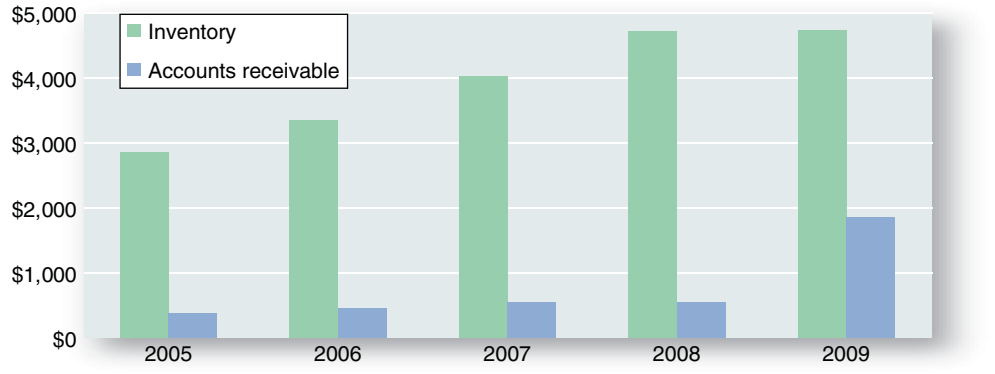
SOURCE: *Best Buy Co., Inc.*

EXHIBIT 4
Long Term Debt and Cash, Best Buy Co., Inc.



SOURCE: *Best Buy Co., Inc.*

EXHIBIT 5
Accounts Receivable and Inventory, Best Buy Co., Inc.



SOURCE: *Best Buy Co., Inc.*

Best Buy's long-term debt increased substantially from fiscal 2008 to 2009 (see **Exhibit 4**), which was primarily due to the acquisition of Napster and Best Buy Europe. The trend in available cash has been a mirror image of long-term debt. Available cash increased from fiscal 2005 to 2008 and then was substantially lower in 2009 for the same reason.

While the change in available cash and long-term debt were not desirable, the bright side was that this situation was due to the acquisition of assets, which led to a significant increase in revenue for the company. Ultimately, the decreased availability of cash would seem to be temporary due to the circumstances. The more troubling concern was the decline in net income and operating margins, which Best Buy needed to find a way to turn around. If the problems with net income and operating margins were fixed, the trends in cash and long-term debt would also begin to turn around.

At first blush, the increase in accounts receivable and inventory was not necessarily alarming since revenues were increasing during this same time period (see **Exhibit 5**). However,

closer inspection revealed a 1% increase in inventory from fiscal 2008 to 2009 and a 12.5% increase in revenue accompanied by a 240% increase in accounts receivable. This created a potential risk for losses due to bad debts. (For complete financial statements, see **Exhibits 6 and 7.**)

Marketing

Best Buy's marketing goals were four-fold: (1) to market various products based on the customer centricity operating model, (2) to address the needs of customer lifestyle groups, (3) to be at the forefront of technological advances, and (4) to meet customer needs with end-to-end solutions.

Best Buy prided itself on customer centricity that catered to specific customer needs and behaviors. Over the years, the retailer created a portfolio of products and services that complemented one another and added to the success of the business. These products included seven distinct brands domestically, as well as other brands and stores internationally:

Best Buy: This brand offered a wide variety of consumer electronics, home office products, entertainment software, appliances, and related services.

Best Buy Mobile: These stand-alone stores offered a wide selection of mobile phones, accessories, and related e-services in small-format stores.

Geek Squad: This brand provided residential and commercial product repair, support, and installation services both in-store and on-site.

Magnolia Audio Video: This brand offered high-end audio and video products and related services.

Napster: This brand was an online provider of digital music.

Pacific Sales: This brand offered high-end home improvement products primarily including appliances, consumer electronics, and related services.

Speakeasy: This brand provided broadband, voice, data, and information technology services to small businesses.

Starting in 2005, Best Buy initiated a strategic transition to a customer-centric operating model, which was completed in 2007. Prior to 2005, the company focused on customer groups such as affluent professional males, young entertainment enthusiasts, upscale suburban mothers, and technologically advanced families.[6] After the transition, Best Buy focused more on customer lifestyle groups such as affluent suburban families, trendsetting urban dwellers, and the closely knit families of Middle America.[7] To target these various segments, Best Buy acquired firms with aligned strategies, which were used as a competitive advantage against its strongest competition, such as Circuit City and Wal-Mart. The acquisitions of Pacific Sales, Speakeasy, and Napster, along with the development of Best Buy Mobile, created more product offerings, which led to more profits.

Marketing these different types of products and services was a difficult task. That was why Best Buy's employees had more training than competitors. This knowledge service was a value-added competitive advantage. Since the sales employees no longer operated on a commission-based pay structure, consumers could obtain knowledge from salespeople without being subjected to high-pressure sales techniques. This was generally seen to enhance customer shopping satisfaction.

Operations

Best Buy's operating goals included increasing revenues by growing its customer base, gaining more market share internationally, successfully implementing marketing and sales strategies in Europe, and having multiple brands for different customer lifestyles through M&A (Merger and Acquisition).

Domestic Best Buy store operations were organized into eight territories, with each territory divided into districts. A retail field officer oversaw store performance through district

managers, who met with store employees on a regular basis to discuss operations strategies such as loyalty programs, sales promotion, and new product introductions.[8] Along with domestic operations, Best Buy had an international operation segment, originally established in connection with the acquisition of Canada-based Future Shop.[9]

In fiscal 2009, Best Buy opened up 285 new stores in addition to the European acquisition of 2,414 Best Buy Europe stores, relocated 34 stores, and closed 67 stores.

Human Resources

The objectives of Best Buy's human resources department were to provide consumers with the right knowledge of products and services, to portray the company's vision and strategy on an everyday basis, and to educate employees on the ins and outs of new products and services. Best Buy employees were required to be ethical and knowledgeable. This principle started within the top management structure and filtered down from the retail field officer through district managers, and through store managers to the employees on the floor. Every employee must have the company's vision embedded in their service and attitude.

Despite Best Buy's efforts to train an ethical and knowledgeable employee force, there were some allegations and controversy over Best Buy employees, which gave the company a bad black eye in the public mind. One lawsuit claimed that Best Buy employees had misrepresented the manufacturer's warranty in order to sell its own product service and replacement plan. The lawsuit accused Best Buy of "entering into a corporate-wide scheme to institute high-pressure sales techniques involving the extended warranties" and "using artificial barriers to discourage consumers who purchased the 'complete extended warranties' from making legitimate claims."[10]

In a more recent case (March 2009), the U.S. District Court granted Class Action certification to allow plaintiffs to sue Best Buy for violating its "Price Match" policy. According to the ruling, the plaintiffs alleged that Best Buy employees would aggressively deny consumers the ability to apply the company's "price match guarantee."[11] The suit also alleged that Best Buy had an undisclosed "Anti-Price Matching Policy," where the company told its employees not to allow price matches and gave financial bonuses to employees who complied.

Competition

Brick-and-Mortar Competitors

Wal-Mart Stores Inc., the world's largest retailer, with revenues over US$405 billion, operated worldwide and offered a diverse product mix with a focus on being a low-cost provider. In recent years, Wal-Mart increased its focus on grabbing market share in the consumer electronics industry. In the wake of Circuit City's liquidation,[12] Wal-Mart was stepping up efforts by striking deals with Nintendo and Apple that would allow each company to have their own in-store displays. Wal-Mart also considered using Smartphones and laptop computers to drive growth.[13] It was refreshing 3,500 of its electronics departments and was beginning to offer a wider and higher range of electronic products. These efforts should help Wal-Mart appeal to the customer segment looking for high quality at the lowest possible price.[14]

GameStop Corp. was the leading video game retailer with sales of almost US$9 billion as of January 2009, in a forecasted US$22 billion industry. GameStop operated over 6,000 stores throughout the United States, Canada, Australia, and Europe, as a retailer of both new and used video game products including hardware, software, and gaming accessories.[15]

The advantage GameStop had over Best Buy was the number of locations: 6,207 GameStop locations compared to 1,023 Best Buy locations. However, Best Buy seemed to

have what it took to overcome this advantage—deep pockets. With significantly higher net income, Best Buy could afford to take a hit to its margins and undercut GameStop prices.[16]

RadioShack Corp. was a retailer of consumer electronic goods and services including flat panel televisions, telephones, computers, and consumer electronic accessories. Although the company grossed revenues of over US$4 billion from 4,453 locations, RadioShack consistently lost market share to Best Buy. Consumers had a preference for RadioShack for audio and video components, yet preferred Best Buy for their big box purchases.[17]

Second tier competitors were rapidly increasing. Wholesale shopping units were becoming more popular, and companies such as Costco and BJ's had increased their piece of the consumer electronics pie over the past few years. After Circuit City's bankruptcy, mid-level electronics retailers like HH Gregg and Ultimate Electronics were scrambling to grab Circuit City's lost market share. Ultimate Electronics, owned by Mark Wattles, who was a major investor in Circuit City, had a leg up on his competitors. Wattles was on Circuit City's board of executives and had firsthand access to profitable Circuit City stores. Ultimate Electronics planned to expand its operations by at least 20 stores in the near future.

Online Competitors

Amazon.com Inc., since 1994, had grown into the United States' largest online retailer with revenues of over US$19 billion in 2008 by providing just about any product imaginable through its popular website. Created as an online bookstore, Amazon soon ventured out into various consumer electronic product categories including computers, televisions, software, video games, and much more.[18]

Amazon.com gained an advantage over its supercenter competitors as Amazon was able to maintain a lower cost structure compared to brick-and-mortar companies such as Best Buy. Amazon was able to push those savings through to its product pricing and selection/diversification. With an increasing trend in the consumer electronic industry to shop online, Amazon.com was positioned perfectly to maintain strong market growth and potentially steal some market share away from Best Buy.

Netflix Inc. was an online video rental service, offering selections of DVDs and Blu-ray discs. Since its establishment in 1997, Netflix had grown into a US$1.4 billion company. With over 100,000 titles in its collection, the company shipped for free to approximately 10 million subscribers. Netflix began offering streaming downloads through its website, which eliminated the need to wait for a DVD to arrive.

Netflix was quickly changing the DVD market, which had dramatically impacted brick-and-mortar stores such as Blockbuster and Hollywood Video and retailers who offered DVDs for sale. In a responsive move, Best Buy partnered with CinemaNow to enter the digital movie distribution market and counter Netflix and other video rental providers.[19]

Core Competencies

Customer Centricity Model

Most players in the consumer electronics industry focused on delivering products at the lowest cost (Wal-Mart—brick-and-mortar, Amazon—web-based). Best Buy, however, took a different approach by providing customers with highly trained sales associates who were available to educate customers regarding product features. This allowed customers to make informed buying decisions on big-ticket items. In addition, with the Geek Squad, Best Buy was able to offer and provide installation services, product repair, and ongoing support. In short, Best Buy provided an end-to-end solution for its customers.

Best Buy used its customer centricity model, which was built around a significant database of customer information, to construct a diversified portfolio of product offerings. This allowed the company to offer different products in different stores in a manner that matched customer needs. This in turn helped keep costs lower by shipping the correct inventory to the correct locations. Since Best Buy's costs were increased by the high level of training needed for sales associates and service professionals, it had been important that the company remain vigilant in keeping costs down wherever it can without sacrificing customer experience.

The tremendous breadth of products and services Best Buy was able to provide allowed customers to purchase all components for a particular need within the Best Buy family. For example, if a customer wanted to set up a first-rate audio-visual room at home, he or she could go to the Magnolia Home Theater store-within-a-store at any Best Buy location and use the knowledge of the Magnolia or Best Buy associate in the television and audio areas to determine which television and surround sound theater system best fit their needs. The customer could then employ a Geek Squad employee to install and set up the television and home theater system. None of Best Buy's competitors offered this extensive level of service.

Successful Acquisitions

Through its series of acquisitions, Best Buy had gained valuable experience in the process of integrating companies under the Best Buy family. The ability to effectively determine where to expand was important to the company's ability to differentiate itself in the marketplace. Additionally, Best Buy was also successfully integrating employees from acquired companies. Best Buy had a significant global presence, which was important because of the maturing domestic market. This global presence provided the company with insights into worldwide trends in the consumer electronics industry and afforded access to newly developing markets. Best Buy used this insight to test products in different markets in its constant effort to meet and anticipate customer needs.

Retaining Talent

Analyzing Circuit City's demise, many experts concluded one of the major reasons for the company's downfall was that Circuit City let go of their most senior and well-trained sales staff in order to cut costs. Best Buy, on the other hand, had a reputation for retaining talent and was widely recognized for its superior service. Highly trained sales professionals had become a unique resource in the consumer electronics industry, where technology was changing at an unprecedented rate, and was a significant source of competitive advantage.

Challenges Ahead

Economic Downturn

Electronics retailers like Best Buy sold products that could be described as "discretionary items, rather than necessities."[20] During economic recessions, however, consumers had less disposable income to spend. While there was optimism about a possible economic turnaround in 2010 or 2011, if the economy continued to stumble, this could present a real threat to sellers of discretionary products.

In order to increase sales revenues, many retailers, including Best Buy, offered customers low interest financing through their private-label credit cards. These promotions were tremendously successful for Best Buy. From 2007 to 2009, these private-label credit card purchases

accounted for 16%–18% of Best Buy's domestic revenue. Due to the credit crisis, however, the Federal Reserve issued new regulations that could restrict companies from offering deferred interest financing to customers. If Best Buy and other retailers were unable to extend these credit lines, it could have a tremendous negative impact on future revenues.[21]

Pricing and Debt Management

The current depressed economic conditions, technological advances, and increased competition put a tremendous amount of pricing pressure on many consumer electronics products. This was a concern for all companies in this industry. The fact that Best Buy did not compete strictly on price structure alone made this an even bigger concern. Given the higher costs that Best Buy incurred training employees, any pricing pressure that decreased margins put stress on Best Buy's financial strength. In addition, the recent acquisition of Napster and the 50% stake in Best Buy Europe significantly increased Best Buy's debt and reduced available cash. Even in prosperous times, debt management was a key factor in any company's success, and it became even more important during the economic downturn. (See **Exhibits 6** and **7** for Best Buy's financial statements.)

Products and Service

As technology improved, product life cycles, as well as prices, decreased. As a result, margins decreased. Under Best Buy's service model, shorter product life cycles increased training costs. Employees were forced to learn new products with higher frequency. This was not only costly but also increased the likelihood that employees would make mistakes, thereby tarnishing Best Buy's service record and potentially damaging one of its most important, if not the most important, differentiators. In addition, more resources would be directed at research of new products to make sure Best Buy continued to offer the products consumers desire.

One social threat to the retail industry was the growing popularity of the online marketplace. Internet shoppers could browse sites searching for the best deals on specific products. This technology allowed consumers to become more educated about their purchases, while creating increased downward price pressure. Ambitious consumers could play the role of a Best Buy associate themselves by doing product comparisons and information gathering without a trip to the store. This emerging trend created a direct threat to companies like Best Buy, which had 1,023 stores in its domestic market alone. One way Best Buy tried to continue the demand for brick-and-mortar locations and counter the threat of Internet-based competition was by providing value-added services in stores. Customer service, repairs, and interactive product displays were just a few examples of these services.[22]

Leadership

The two former CEOs of Best Buy, Richard Shultze and Brad Anderson, were extremely successful at making the correct strategic moves at the appropriate times. With Brad Anderson stepping aside in June 2009, Brian Dunn replaced him as the new CEO. Although Dunn worked for the company for 24 years and held the key positions of COO and President during his tenure, the position of CEO brought him to a whole new level and presented new challenges, especially during the economic downturn. He was charged with leading Best Buy into the world of increased connectivity. This required a revamping of products and store setups to serve customers in realizing their connectivity needs. This was a daunting task for an experienced CEO, let alone a new CEO who had never held the position.

EXHIBIT 6 Consolidated Balance Sheets, Best Buy Co., Inc.

$ in millions, except per share and share amounts

	February 28, 2009	March 1, 2008
ASSETS		
Current Assets:		
Cash and cash equivalents	$498	$1,438
Short-term investments	11	64
Receivables	1,868	549
Merchandise inventories	4,753	4,708
Other current assets	1,062	583
Total current assets	8,192	7,342
Property and Equipment:		
Land and buildings	755	732
Leasehold improvements	2,013	1,752
Fixtures and equipment	4,060	3,057
Property under capital lease	112	67
	6,940	5,608
Less accumulated depreciation	2,766	2,302
Net property and equipment	4,174	3,306
Goodwill	2,203	1,088
Tradenames	173	97
Customer Relationships	322	5
Equity and Other Investments	395	605
Other Assets	367	315
Total Assets	$15,826	$12,758
LIABILITIES AND SHAREHOLDERS' EQUITY		
Current Liabilities:		
Accounts payable	$4,997	$4,297
Unredeemed gift card liabilities	479	531
Accrued compensation and related expenses	459	373
Accrued liabilities	1,382	975
Accrued income taxes	281	404
Short-term debt	783	156
Current portion of long-term debt	54	33
Total current liabilities	8,435	6,769
Long-Term Liabilities	1,109	838
Long-Term Debt	1,126	627
Minority Interests	513	40
Shareholders' Equity:		
Preferred stock, $1.00 par value: Authorized — 400,000 shares; Issued and outstanding — none	—	—
Common stock, $0.10 par value: Authorized — 1.0 billion shares; Issued and outstanding — 413,684,000 and 410,578,000 shares, respectively	41	41
Additional paid-in capital	205	8
Retained earnings	4,714	3,933
Accumulated other comprehensive (loss) income	(317)	502
Total shareholders' equity	4,643	4,484
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	$15,826	$12,758

SOURCE: *Best Buy Co., Inc. 2009 Form 10-K, p. 56.*

EXHIBIT 7 Consolidated Statements of Earnings, Best Buy Co., Inc.

$ in millions, except per share amounts

Fiscal Years Ended	February 28, 2009	March 1, 2008	March 3, 2007
Revenue	$45,015	$40,023	$35,934
Cost of goods sold	34,017	30,477	27,165
Gross profit	10,998	9,546	8,769
Selling, general and administrative expenses	8,984	7,385	6,770
Restructuring charges	78	—	—
Goodwill and tradename impairment	66	—	—
Operating income	1,870	2,161	1,999
Other income (expense)			
Investment income and other	35	129	162
Investment impairment	(111)	—	—
Interest expense	(94)	(62)	(31)
Earnings before income tax expense, minority interests and equity in income (loss) of affiliates	1,700	2,228	2,130
Income tax expense	674	815	752
Minority interests in earnings	(30)	(3)	(1)
Equity in income (loss) of affiliates	7	(3)	—
Net earnings	$1,003	$1,407	$1,377
Earnings per share			
Basic	$2.43	$3.20	$2.86
Diluted	$2.39	$3.12	$2.79
Weighted-average common shares outstanding (in millions)			
Basic	412.5	439.9	482.1
Diluted	422.9	452.9	496.2

SOURCE: *Best Buy Co., Inc. 2009 Form 10-K, p. 57.*

Wal-Mart

Best Buy saw its largest rival, Circuit City, go bankrupt. However, a new archrival, Wal-Mart, was expanding into consumer electronics and stepping up competition in a price war Wal-Mart hoped to win. Best Buy needed to face the competition not by lowering prices, but by coming up with something really different. Best Buy had to determine the correct path to improve its ability to differentiate itself from competitors, which was increasingly difficult given an adverse economic climate and the company's financial stress. How Best Buy could maintain innovative products, top-notch employees, and superior customer service while facing increased competition and operational costs was an open question.

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CASE 25

The Future of Gap Inc.

Mridu Verma

Gap Inc.'s heritage is based on connecting with people through great style and experiences—and by making cultural connections along the way.
ROBERT FISHER, CHAIRMAN, GAP INC.[1]

GAP INC. WAS ONE OF THE LEADING INTERNATIONAL SPECIALTY RETAILERS OFFERING CLOTHING, accessories and personal care products for men, women, children, and babies under the Gap, Banana Republic, Old Navy, and Forth & Towne brand names. The company primarily operated in North America. The company recorded revenues of $16.023 billion during the fiscal year ended January 2006, a decrease of 1.5% over 2005. The operating profit of the company was $1.79 billion during fiscal year 2006, a decrease of 4.2% over 2005. The net profit was $1.113 billion, a decrease of 3.2% over 2005. Gap was ranked 52nd (2005 ranking—40th) by the Business Week Interbrand survey conducted in August 2006. It was valued at $6416 million ($8195 million in 2005). (See **Exhibits 1 and 2** for Gap's financial results.)

Paul Pressler (Pressler), who became Gap Inc.'s CEO in October 2002, had been heralded for his cost-cutting strategies that had restored financial discipline in the company. But there was a trade-off, analysts said. Pressler, who had little retail experience, did not steer Gap toward its customers' tastes. Realizing his mistakes, Pressler changed his strategy in mid-2004 to generate growth. Would he succeed in rejuvenating Gap Inc. and attracting customers once again? (See **Exhibit 3** for a brief SWOT analysis.)

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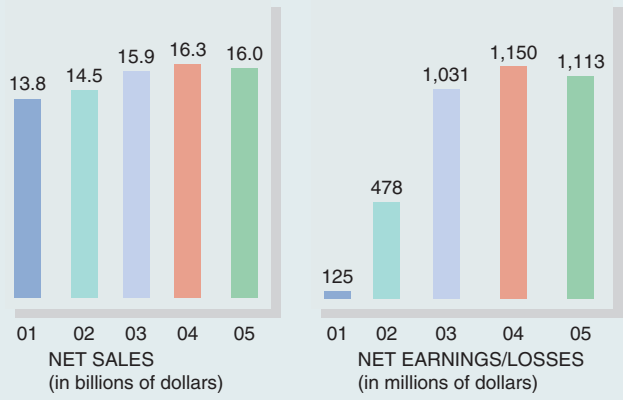
EXHIBIT 1
Financial Results: Gap Inc.

Year Ending	January 28, 2006	January 29, 2005	January 31, 2004
Net Sales	**$16,023**	**$16,267**	**$15,854**
Percentage change year-to-date	(2%)	3%	10%
Earnings before income taxes	$1,793	$1,872	$1,684
Percentage change year-to-date	(4%)	11%	110%
Net Earnings	**$1,113**	**$1,150**	**$1,031**
Percentage change year-to-date	(3%)	12%	116%
Cash Flows			
Net cash provided by operating activities	$1,551	$1,597	$2,160
Net cash provided by (used for) investing activites	286	183	(2,318)
Effect of exchange rate fluctations on cash	(7)	-	28
Net decrease in cash and equivalents	(210)	(16)	(261)
Net cash provided by operating activities	$1,551	$1,597	$2,160
Less: Net purchases of property and equipment	(600)	(419)	(261)
Free cash flow	$961	$1,176	$1,899

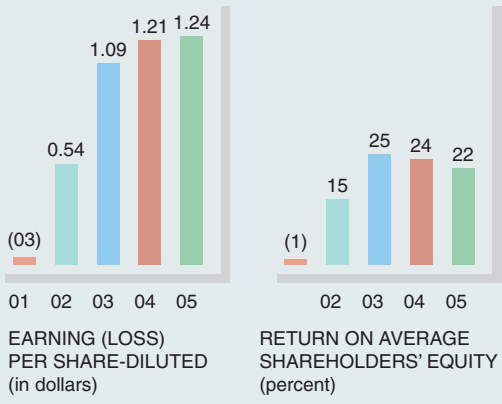
SOURCE: *Gap Inc. Annual Report 2005.*

EXHIBIT 2
Select Financial Results: Gap Inc.

A. Sales and Earnings: Gap Inc.



B. Financial Information: Gap Inc.



SOURCE: *Gap Inc. Annual Report 2005.*

EXHIBIT 3
SWOT Analysis: Gap Inc.

Strengths	Weaknesses
Brand recognition	Weak performance of Gap brand
Large network of physical stores	Overdependence on North America
Low long-term debt	Declining operating cash flows
Opportunities	**Threats**
Launch of Forth & Towne	Counterfeit products
Growth in online retail spending	Slowdown in consumer spending
Markets in China and India	Emergence of private labels

SOURCE: *Gap Inc. Annual Report 2005.*

About Gap Inc.

Gap Inc. was a specialty retailer operating retail and outlet stores selling casual apparel, accessories, and personal care products for men, women, and children under the Gap, Banana Republic, Old Navy, and Forth & Towne brands. Gap division's brands also included GapKids, babyGap, and GapBody. In June 2006, the company operated 3,070 stores, including Gap, Banana Republic, and Old Navy stores throughout the U.S., as well as in Canada, the UK, France, and Japan. In addition, the company also marketed its products to its U.S. customers through three Web sites: gap.com, bananarepublic.com, and oldnavy.com.

The company primarily conducted its business through four business divisions: Old Navy, Gap, Banana Republic, and others. Old Navy targeted cost-conscious shoppers. Old Navy stores offered selections of apparel, shoes, and accessories for adults, children, and infants as well as other items, including personal care products. Old Navy also offered a line of maternity and plus sizes in its stores. The Old Navy division recorded revenues of $6.86 billion in fiscal year 2006, an increase of 1.6% over 2005. The Gap division offered extensive selections of classically styled, casual apparel at moderate price points, usually priced higher than Old Navy apparel. It also offered accessories and personal care products. The brand extensions of the Gap included GapKids, babyGap, and GapBody. During the fiscal year 2006, the Gap division recorded revenues of $6.84 billion, a decrease of 5.6% over 2005.

The Banana Republic brand offered a more sophisticated dress-casual and tailored apparel, shoes, and accessories for adults. Its products ranged from apparel, including intimate apparel, to personal care products. The Banana Republic division recorded revenues of $2.3 billion in fiscal year 2006, an increase of 1.4% over 2005. Other divisions included Forth & Towne and direct, as well as international sales programmers. Forth & Towne was the company's newest retail concept, principally targeting women over the age of 35. The "other" division recorded revenues of $29 million in fiscal year 2006, as compared to the revenues of $11 million in fiscal 2005. The bulk of Gap Inc.'s sales came from Gap and Old Navy, with Banana Republic and a new chain, Forth & Towne, representing less than 25% of its business. North America, Gap's largest geographical market, accounted for 90.9% of the total revenues in the fiscal year 2006. Revenues from North America reached $14.56 billion in 2006, a decrease of 1.4% over 2005. Europe accounted for 5.1% of the total revenues in the fiscal year 2006.

Background Note

Gap

Gap was set up by Donald Fisher in 1969. After a pair of Levi's jeans purchased by him fell short of his size requirements, Fisher sensed a gap in the market. He decided to start an only-jeans outlet that offered a wide range of sizes to the customers. With this intention, the first store was started in San Francisco. To reinforce the choices available at the stores, Gap's first advertisement carried the tag line "four tons of Levi's." The retail concept was an instant hit. Gap's "basics look" comprising signature (Levi's) blue jeans and white cotton shirts became a rage. Initially the goods were sold at Levi's controlled prices, allowing Fisher to earn hefty margins (in the region of 50%). A 1976 Federal Trade Commission (FTC) directive banned manufacturers from setting the retail price. With an increasing number of retailers discounting their retail offerings, competition in the market heated up and margins dried up. Fisher parted ways with Levi's and shifted to high-margin private labels. By 1980, 200 Gap outlets in the U.S. offered 14 different private labels, such as Foxtails, Monterey Bay, and Durango. As other retailers started taking the same private label route to bolster their margins. Gap seemed to be getting lost in the crowd. It was at this juncture that Fisher hired Millard "Mickey" Drexler (Drexler) to give a new direction to Gap.

When Drexler joined Gap in 1983, the company's turnover was just $500 million. He dumped the private-label brands and introduced Gap as a clothing brand. Soon, Gap controlled everything from manufacturing to marketing to the distribution of its offerings. Gap took advantage of America's casual-dress trend. Whenever growth appeared to slow, Drexler came up with something new: GapKids, babyGap, and then discount stores. Gap led the corporate dress-down revolution, and earnings grew at an average of 30% for the five years through 1999. In the mid-1990s, the Gap was so much a part of American pop culture that it warranted its own skit on Saturday Night Live. Unfortunately, Gap's khakis-and-blue-shirt formula proved remarkably easy to replicate. The company soon found itself competing with discount retailers such as Target and Wal-Mart.

When laid-off dot-commers stopped loading up on casual clothes, Gap took desperate measures to lift sales, stocking trendy miniskirts and low-rise jeans to chase teenage shoppers. Its purple shirts in extra large sizes did not find any buyers. Gap's core 30-and-over clientele, once Gap's mainstay, fled to rivals such as value retailers Target and Kohl's.

Banana Republic

Started by Mel and Patricia Ziegler in 1978, Banana Republic was positioned as an adventure lifestyle store. It retailed bush jackets, travel trunks, travel books, fisherman hats, and exotic maps with most of its sales coming through catalogues. Its ascent coincided with the "safari fever"[2] spreading across the U.S. in the early 1980s. When Banana Republic's sales touched the $10 million mark in 1983, its stores were bought by Gap.

Gap transformed Banana Republic from a catalog-based retailer to a physical retailer with large stores across the country. The stores offered lifestyle apparels tailored to consumers needs. By 1987, Banana Republic was a successful retail concept with sales revenue of $191 million. With safaris going out of fashion, Banana Republic's fortunes plunged. It reported a loss of $10 million in 1988. Banana underwent a makeover and shed its safari-style merchandise in favor of clothes for the dressed-down workplace, a strategy that sustained it through the dot-com era. The emphasis was on a "modern casual lifestyle" look. Banana Republic was struggling to come up with a fashion mix that its 30-and-older customers, especially men, felt more comfortable wearing.

Old Navy

Started in 1994, Old Navy targeted price-conscious customers. Old Navy apparels used different fabrics as compared to Gap and the stores were given a "fun" look.[3] Using different blends of fabric that helped keep its manufacturing costs low, Old Navy retailed basics for the whole family at two-thirds Gap's prices. It sold budget-priced jeans, T-shirts, and khaki pants to kids, teens, and young adults. Thanks to a very successful season of fleece tops and vests, Old Navy became the biggest contributor to the parent company's overall growth in 2000, even when sales declined at the core Gap chain.

Encouraged by the sales, Drexler opened 282 Old Navy stores in the next three years. Old Navy became the first-ever retail chain to reach $1 billion sales within four years. In 2004, Old Navy accounted for 41% of Gap Inc.'s total sales. Though comparatively successful, Old Navy had its own share of problems. Consumers complained that it was always bulging with merchandise, with the floor often being permanently devoted to discounted goods to boost sales. In 2000, Old Navy shifted its focus to teenagers. Initially, the brand was immensely popular among teenagers, but soon the brand became a casualty of teenagers' fickle preferences.

"Old Navy's been a bit of a problem child for them recently. In some ways it became a victim of its own success. The younger crowd went crazy for them and they met that demand, but now they're realizing that they need to appeal to a larger audience," an analyst observed.[4] Old Navy, whose merchandise mix was skewed too far toward teens in 2001, needed to win back grownups. Old Navy also needed to restore a distinct identity to avoid drawing bargain-hunting Gap shoppers.

Drexler acknowledged that each of the company's three core brands—Gap, Banana Republic, and Old Navy—had "come untethered from the tight rapport with consumers that accounted for its earlier prosperity." In the mid-1990s, Gap had embarked on an expansion spree, increasing its retail square footage by more than 20% annually. Square footage at Gap's three chains doubled between 1999 and 2002 even as sales per square foot plunged from $548 to $393 during the same period. In 2001, Gap posted a loss of $7.8 million on sales of $13.8 billion.[5] By March 2002, rating agencies had downgraded Gap Inc.'s debt from investment grade to junk. Heavy markdowns sliced Gap's gross margins by 40%. In 2002, Gap paid interest worth $145 million on the $2 billion debt it had raised to fund its expansion plans. To make things worse, Gap's per-store sales declined for 29 months straight as profits vanished. Drexler stepped down in September 2002. He was replaced by Paul Pressler (Pressler), who had been running Disney's consumer stores (which were later sold) and the Disneyland theme park (where he expanded the souvenir shops and restaurants), and oversaw all Disney parks and resorts, but had no previous fashion retail experience.

Pressler's Turnaround Strategy

Initially, Pressler focused on cost cutting, consumer research, and more targeted marketing of the three brands. Working with CFO Byron Pollitt (Pollitt), whom he had brought over from Disney, Pressler shut down hundreds of stores, consolidated production among fewer suppliers, and revamped inventory management. He reduced the inventory per square foot by 16%. He attempted to increase margins by selling clothes closer to full price. To end panicky clearance sales, Pressler ordered managers to rely increasingly on software that would tell them when and by how much to mark down merchandise. Micro-management was replaced by hands-off leadership. Pressler was not as interested in product details. He left specific color and design decisions to Gap, Old Navy, and Banana Republic division heads. Pressler devoted more attention to areas visible to the customer, including marketing and store atmosphere.

He hired what he called a "chief algorithm officer" to analyze the sales from every cash register. It turned out that Gap had been sending the same size assortments to stores with different

selling patterns. He initiated customized deliveries—for instance, sending more extra-larges to places that needed them. Each chain also instituted "guardrails" that defined what portion of a store's inventory should go toward basic colors and styles regardless of how varied the floor displays were. All this served to cut the need for discounting, and profit margins improved.

When it came to the merchandise, Pressler also resorted to "numbers." Consumer-insight research showed that the three brands were losing market share. With the distinction between the products of the three brands becoming hazy, each seemed to be eating into the other's market share. He decided to reposition all the three brands, giving each a distinctive identity. While Gap stayed in the middle, Old Navy focused on lower prices and basic items, and Banana Republic raised prices and experimented with runway-influenced designs. The strategy yielded results in the early days. In 2003, the business bounced back after 29 straight months of same-store sales declines under Drexler. Cash flow from operations went up and Gap's credit rating rose.

The Decline

In July 2004 the turnaround hit a snag with each of the three chains' sales heading southward, pushing comparable sales down 5%. After initial success in distinguishing brands, Pressler's reliance on metrics prompted him to distinguish them even further, and the move backfired. Old Navy, known for its specialty style at discounted prices, disappointed its faithful by stocking commodity T-shirts and jeans similar to those sold at discount chains such as Target, in the place of the trendy-but-cheap clothes it had stocked earlier. Banana Republic went over the top, devoting too much of its space to embellished pieces unsuitable for the office. As for the Gap brand, it started marketing outfits instead of individual staples like khakis and denim. The Gap stores sported separate "going out" and "go to work" sections—making it harder for the customers to navigate. Shoppers who had once considered Banana, Gap, and Old Navy as default choices gravitated to fresher competitors like Abercrombie & Fitch, Urban Outfitters, and J. Crew (rival clothing retailers).

An exodus of sorts was underway inside the company too. Soon after Drexler's departure, a stream of talented executives who had helped make Gap great in its heyday began to head for the exits, from executive vice presidents to in-the-trenches designers (see **Exhibit 4**). Some

EXHIBIT 4
Employee Exodus: Gap Inc.

Employee Name	Year of Departure	Name of the Company Joined
Mickey Drexler CEO	2002	J. Crew
Jeff Pfeifle EVP, product and design, Old Navy	2002	J. Crew
Henry Stafford Merchandiser, Old Navy men's	2003	American Eagle Outfitters
Jerome Jessup EVP, product development and design, Gap brands	2003	Ann Taylor
Maureen Chiquet President, Banana Republic	2003	Chanel
Neil Goldberg President, Gap Inc. outlets	2003	The Children's Place
Michael Tucci EVP, Gap Inc. online division	2003	Coach

EXHIBIT 4
(Continued)

John Goodman SVP, Gap Inc. outlets	2003	Dockers
Jennifer Foyle Divisional merchandising manager, Gap brand, women's	2003	J. Crew
Lynda Markoe Senior director, Gap Inc. HR	2003	J. Crew
Todd Snyder Senior director, Old Navy, men's product design	2003	J. Crew
John Valdivia VP, creative services, Old Navy	2003	J. Crew
Libby Wadle Div. merchandising manager, Banana Republic, women's	2003	J. Crew
Roxane Al-Fayez VP, operations, Gap Inc. online division	2003	Limited Brands
Thomas Cawley CFO, Gap brand	2003	Peet's Coffee & Tea
Patti Barkin-Camilli SVP, Old Navy, women's accessories	2003	Uniqlo
LeAnn NealzSVP, design, GapKids, babyGap SVP, design, GapKids, babyGap	2004	American Eagle Outfitters
Barbara Wambach EVP, Gap Body	2004	Bebe
Tara Poseley SVP, merchandising, GapKids, babyGap	2004	Design Within Reach
Tracy Gardner SVP, merchandising, Gap brand	2004	J. Crew
Mark Breitbard SVP, merchandising, Gap Kids, babyGap	2005	Abercrombie & Fitch
Alan Marks VP, corporate communications, Gap Inc.	2005	Nike
Pina Ferlisi EVP, design, Gap brand	2005	Generra
Jeff Jones EVP, marketing, Gap brand	2005	No announced destination
Felix Carbullido VP and general manager, Gap.com	2006	Smith & Hawken
Alan Barocas SVP, real estate, Gap Inc.	2006	No announced destination
Nick Cullen EVP, chief supply chain officer, Gap Inc.	2006	No announced destination
Jyothi Rao VP, merchandising, Forth & Towne	2006	No announced destination
Julie Rosen VP, merchandising, Gap brand	2006	No announced destination

SOURCE: *Prepared from information provided in Julia Boorstin, "Fashion Victim,"* Fortune, *4/17/2006, Vol. 153 Issue 7, p. 160–166.*

were fired, others left on their own. "From the day I got here, we've had to assess our talent," mentioned Pressler,[6] who called the turnover healthy and normal. But analysts and industry observers were not so sanguine, with some analysts downgrading the company. Morgan Stanley analyst Michelle Clark opined that with other ex-Disney players such as Gap-brand head Cynthia Harriss in key roles, the company's lack of fashion expertise at the top was being exacerbated by a drain of youthful morale and energy. Even company insiders echoed her fears. "Ten of the best 15 executives in all retail were working for the company. Now they've lost the creative people, almost all the merchandising and design leadership," observed a former head of one Gap division.[7]

By the time Pressler faced investors in Spring 2005, the momentum he had built up in his first 18 months was gone. He tried to shift Wall Street's focus to the future, announcing that the company would introduce a new store chain, Forth & Towne, for women 35 and over. More privately, he went back to the core brands, working with their respective presidents to analyze customer surveys. The identity of each chain was recalibrated: Gap would offer high-quality basics with style; Banana Republic would emphasize fashionable classics but avoid the cutting edge; Old Navy would rededicate itself to low-priced trendy items. Pressler also cut the nine-month production cycle on some Old Navy clothes to three months—so it could adapt to emerging trends more readily—by moving designers from New York to its San Francisco headquarters, positioning some merchants closer to factories in Southeast Asia, and sourcing more items in North America. Gap's 2005 fall line featured its classic navy, gray, crisp white, and denim, plus some richer materials—washed leather and cotton cashmere. Meanwhile, Banana Republic pulled back from fashion extremes and was focusing on the classics. At Old Navy—to which Pressler was looking for a big chunk of the company's growth—product quality was improved noticeably.

Gap continued to face a perception problem—a struggle to recapture customers who had abandoned it. Fiscally and operationally, Gap was a tighter, stronger business than it was in 2002. Pressler had hedged its fashion bets. Company-commissioned research was directing brand presidents on how they could expand the chains into what Pressler called "lifestyle brands," with line extensions such as accessories and baby-wear. While creating the Forth & Towne chain appeared a gamble, Pressler felt that the numbers pointed to an untapped market. Industry observers, however, opined that no matter how carefully calibrated Gap's fashion choices were, the nature of the business required a certain degree of risk taking. No one knew what consumers would actually buy until the goods were on the shelves.

Pressler also started investing more in the stores, where Gap's minimalist look too often appeared dated and shabby, replacing it with darker-wood fixtures (like Abercrombie), painted walls (like J. Crew), and more dramatic window displays. A back wall dedicated to denim and a colorful "T-shirt bar" highlighted Gap's traditional expertise. New spotlighting, hand-drawn chalk signs, and artful displays of intertwined jeans created a sense of theatricality. By year-end 2005, 60 Gap stores had been redesigned, with another 220 of the chain's 1,335 stores scheduled to get the new look in 2006. The company expected to draw customers into the stores, so that they would notice the better-designed, higher-quality products. In 2005, the company opened 198 new stores and closed 139. In 2006, the company expected to open about 175 store locations, weighted toward the Old Navy brand, and close about 135 store locations, weighted toward the Gap brand. Square footage was expected to increase between 1% and 2% for fiscal year 2006. (See **Exhibit 5.**)

All this came at a financial cost, pushing Gap's capital expenditures to among the highest in specialty retail. It also meant operating margins would drop to between 10% and 10.5% in 2006. For the year 2005, Gap group posted sales of $16 billion, a 2% drop compared with $16.3 billion for 2004. Comparative store sales for the year 2005 decreased by 5%, as against flat sales in 2004. Sales at the flagship Gap stores in the U.S. were essentially flat at $1.2 billion year-over-year in 2005, but sales on the international front lost 5.6% to $339 million from $359 million a year ago. By February 2006, customer traffic across the

EXHIBIT 5

Brand Information: Gap Inc.

A. Brand-wise Financials: Gap Inc.
(Dollars in millions)

52 Weeks Ending January 28, 2006	Gap	Old Navy	Banana Republic	Other	Total
2004 Net Sales	$7,240	$6,747	$2,269	$11	$16,267
Comparable store sales	(302)	(361)	(104)	-	(767)
Noncomparable store sales	(87)	409	130	15	467
Direct (online)	(3)	32	-	3	32
Foreign exchange	(11)	29	6	-	24
2005 Net Sales	$6,837	$6,856	$2,301	$29	$16,023

B. Brand-wise Sales: Gap Inc.
(Dollars in millions)

52 Weeks Ending January 29, 2005	Gap	Old Navy	Banana Republic	Other	Total
2003 Net Sales	$7,305	$6,456	$2,090	$3	$15,854
Comparable store sales	(76)	25	109	-	58
Noncomparable store sales	(155)	195	51	7	98
Direct (online)	16	47	14	-	77
Foreign exchange	150	24	5	1	180
2004 Net Sales	$7,240	$6,747	$2,269	$11	$16,267

C. Brand-wise Store Details: Gap Inc.

Store count and square footage as follows:

	January 28, 2006		January 29, 2005	
	Number of Store Locations	Sq. Ft. (in millions)	Number of Store Locations	Sq. Ft. (in millions)
Gap North America	1,335	12.6	1,396	13.0
Gap Europe	165	1.5	169	1.6
Gap Asia	91	1.0	78	0.8
Old Navy North America	959	18.4	889	17.3
Banana Republic North America	494	4.2	462	3.9
Banana Republic Asia	4	-	-	-
Forth & Towne	5	0.1	-	-
Total	3,053	37.8	2,994	36.6
Increase (Decrease)	2%	3%	(1%)	0%

SOURCE: *Gap Inc. Annual Report 2005.*

Gap, Banana Republic, and Old Navy brands had decreased by 13% from the same point in 2005; same-store sales were down by 11%, and a few more key executives had left.

To fill the executive vacancies, Pressler generally tapped outsiders. Karyn Hillman, senior vice president (SVP) of apparel merchandising for the Banana Republic division, had been promoted to SVP of merchandising for the Gap Adult unit of the flagship Gap brand. Pressler also hired Liz Claiborne veteran Denise Johnston to be president of Gap Adult, overseeing all aspects of Gap's women's and men's apparel and accessories. Pressler realized that fashion retail was not strictly a numbers game, and the quantitative orientation that made Pressler so appealing as an antidote to Drexler—and initially so successful—was ultimately coming back to haunt him. Running a Fortune 500 fashion retailer was a tricky balance between the art of conjuring styles and

the discipline of managing an enormous and far-flung operation. Pressler seemed much more comfortable talking corporate strategy than clothing styles. He defined his task as "meeting investor expectations, building platforms, and building a vision of where we want to go."[8]

Recovery Efforts

In the summer of 2006, Gap launched a new marketing campaign called Rock Color to spotlight summer offerings. Inspired by the summer of 1969, the year the company was founded, the promotion featured a pop-up store, which was actually a converted school bus from the Sixties that would drive to summer resort spots on a mission to sell T-shirts, hoodies, flip-flops, and beach hats. The campaign also involved in-store promotions, windows, print ads, direct-mail, and outdoor ads and an online microsite offering customers the chance to win concert tickets. Color was a key component of the campaign. Gap also introduced a contest for customers in New York, Los Angeles, San Francisco, and Chicago to win tickets to concerts. Additionally, one grand-prize winner would receive a trip for two and backstage passes to Gap's private concert featuring John Legend.

Inspired by the success of Hennes & Mauritz,[9] Gap entered into a partnership with British designer Roland Mouret (Mouret) to launch a capsule collection of dresses in selected stores of Europe and a handful of units in New York. The company hoped to increase traffic to its stores through these initiatives. The move was lauded by analysts. Christine Chen, senior research analyst at Pacific Growth Equities said, "Gap needs to rejuvenate their customer, whom they have been disappointing for two years. Their problem has not been their merchandise, which I think has improved drastically, it's the stigma associated with the brand."[10] Gap had been attempting to recast its image throughout 2006 summer and back-to-school season with the return of television ads, its Audrey Hepburn campaign for the return of basic pants and, most recently, product RED.

The Mouret collection was also a part of the Gap (RED) line and featured 10 dresses, ranging in price from 45 pounds to 78 pounds, or about $85 to $148.[11] Styles included belted shirtdresses; Courreges-inspired numbers and tunics with bib fronts or ruffled V-necks in charcoal, silver-gray, navy, black, and red. The collection was seen by analysts as the next step in bringing back old customers and getting new shoppers interested in the store. Mouret said he had teamed up with Gap for a variety of reasons. "They came to me because they felt they weren't strong in the dress category. They wanted a new project that would take Gap dresses to a new level. I have always been a fan of Gap—I like their laid-back attitude, and it was the right mix of people to work with."[12]

In April 2006, Pressler decided to concentrate on Southeast Asia to generate growth. He entered into a franchise agreement with the leading retailers in Singapore, Kuala Lumpur, Malaysia, and the Middle East to open Gap and Banana Republic stores there. This was the first franchisee agreement entered into by the U.S.-based retailer that had always operated company-owned stores. The main benefit of franchise partners was that they provided the local knowledge and experience to allow the company to quickly tap new markets. The merchandise in the new stores was a franchise-specific mix of products from the North American and European collections as well as items not available in other markets. Prices were about 10 to 15% more in the new stores, mainly because of import costs and high rent.

Looking Ahead

In the third quarter of 2006, Gap Inc. reported a 10.8% decline in third-quarter earnings due in part to sagging sales at Old Navy. Foot traffic to the chains was also on the decline. At Gap, which was all but synonymous with the American mall, sales had fallen every month for the

year 2006, as executives experimented with a dizzying number of fashions and store layouts. In the end, consumers appeared more confused than intrigued by the incessant changes. In the fourth quarter, overall sales fell by 8%, led by Old Navy and to some extent the flagship brand Gap. Interestingly, Banana Republic sales had rebounded. The comeback at Gap Inc. remained a work in progress. A rotating cast of designers had tried to recreate the Gap brand—with expensive handbags, bell-bottom jeans, and evening gowns—but the result was the same: sales fell.

The overall decline in sales prompted the Gap Inc. board to hire Goldman Sachs (Goldman) to explore strategies ranging from the sale of its 3,000 stores to spinning off a single division, such as Banana Republic, which had become enticing to potential buyers. Goldman was expected to conduct a full review of Gap's business lines and then present a plan to directors.

Any decision about Gap's future would be made by the company's founding family, the Fishers, who controlled more than 30% of its stock. A sale of Gap would be one of the largest buyouts ever in the retail industry. The company's prevailing market value in January 2007 was $16.4 billion, and analysts expected that a buyer would have to pay more than $18 billion.

NOTES

1. Chairman's address Gap Inc's Annual Report 2005.
2. Films such as *Raiders of Lost Ark* and *Romancing the Stone* were at their peak during this period.
3. Old Navy had a practical décor, a lively ambiance, and concrete floors unlike hardwood floors at Gap's elite stores.
4. Lee, Louise, "Gap: Missing that Ol' Micky Magic," *Business Week*, October 29, 2001 Issue 3755, p. 86.
5. Gap had posted a profit of $877 million in 2000.
6. Julia. Boorstin, "Fashion Victim," *Fortune,* April 17, 2006, Vol. 153, Issue 7, pp. 160–166.
7. Ibid.
8. Julia Boorstin, "Fashion Victim," *Fortune,* April 17, 2006, Vol. 153, Issue 7, pp. 160–166.
9. While Gap executives downplayed the comparison, the link with Mouret mirrored the strategy H&M had carried out over the last few seasons by teaming up with designers, including Karl Lagerfeld, Stella McCartney and, in 2006, with Viktor & Rolf.
10. Moin, David, "Gap Brand Taps Hillman For Merchandising," *Women's Wear Daily,* December 13, 2006, Vol. 192, Issue 124, p. 11.
11. At December 2006 exchange rate.
12. Moin, David, "Gap Brand Taps Hillman for Merchandising Post." *Women's Wear Daily,* December 13, 2006, Vol. 192, Issue 124, p. 11.

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CASE 26

Rocky Mountain Chocolate Factory Inc. (2008):

RECIPE FOR SUCCESS?

Annie Phan and Joyce Vincelette

Introduction

SITTING AT HIS DESK, ADMIRING THE COLORADO MOUNTAINS IN THE DISTANCE, Frank Crail was counting his blessings at the success of Rocky Mountain Chocolate Factory Inc. (RMCF) over the past 27 years. The company had not only allowed him and his wife to raise their children in Durango, Colorado, but had also provided them a more-than-comfortable livelihood. Crail knew that for his company to continue to grow and be successful, planning for the future was necessary. How long would growth continue in the gourmet segment of the chocolate industry? Consumer tastes were changing. Competition was heating up, with smaller companies being bought by corporate giants who were eying the growth in the gourmet segment of the market. RMCF's business model had been effective, but should changes be considered? With one last glance at the beginnings of springtime in the mountains, Crail left for RMCF's annual planning meeting and his management team waiting in the board room across the hall.

History[1]

Rocky Mountain Chocolate Factory (RMCF) was built around a location and a lifestyle. RMCF began as Frank Crail's dream to move his family from crowded and bustling Southern California, where he owned CNI Data Processing Inc., a company that produced billing software for the

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cable TV industry, to a slower-paced and family-friendly environment. He and his wife chose the small and quaint Victorian-era town of Durango, Colorado, and began surveying the town's residents and merchants for business opportunities. "It came down to either a car wash or a chocolate shop," recalls the father of seven. "I think I made the right choice."[2]

Founded in 1981 by Crail and two partners and incorporated in Colorado in 1982, RMCF was successful from the start. In addition to the opening of the Durango store, Crail's partners opened stores in Breckenridge and Boulder, Colorado. The first franchised stores were opened in 1982 in Colorado Springs, and Park City, Utah. Crail later told *ColoradoBiz* that the "typical franchisee was a professional who wanted to set out on a second career in a small, family-oriented town,"[3] much as he himself had done. Crail's two partners left the business in 1983.

Over the years, RMCF fine-tuned its chocolates and its strategy. In February 1986, Crail took the company public, where it is now found on the NASDAQ under the symbol RMCF. *Chain Store Age* pronounced RMCF founder Frank Crail one of its Entrepreneurs of the Year for 1995. In the late 1990s most of the company-owned retail operations were closed or sold to franchisees, allowing RMCF to focus on franchising and manufacturing.

In 2008, RMCF was an international franchiser and confectionary manufacturer. The original shop "still stands on Main Street in Durango, with its sights and smells tempting tourists and locals alike to experience a cornucopia of chocolaty treats before taking part in a scenic ride on the Durango-Silverton Narrow Gauge Railroad or after a white water rafting trip through town."[4]

As of March 31, 2008, there were five company-owned and 329 franchised RMCF stores operating in 38 states (concentrated primarily on the west coast and in the Sun Belt), Canada, and the United Arab Emirates,[5] with total revenues of $31,878,183.[6]

Frank Crail believed he had created the recipe that had driven the company to success. "The number one factor is the quality of the product," said Crail. "Without that customers aren't going to stay around long."[7] "As a testament, Crail proudly points to a page from *Money* magazine mounted on his office wall, which features Rocky Mountain Chocolate winning the coveted 3-heart rating in a blind taste test. The candy maker's chocolate beat out See's Candies, Perugina, Teuscher, Godiva, and Fanny May for the richest chocolate, with intense natural flavor."[8] In addition to product quality, taste, value, and variety having been key to RMCF's business strategy, the company also believed that its store atmosphere and ambiance, its brand name recognition, its careful selection of sites for new stores and kiosks, its expertise in the manufacture, merchandising and marketing of chocolate and other candy products, and its commitment to customer service were keys to the accomplishment of its objective to build on its position as a leading international franchiser and manufacturer of high quality chocolate and other confectionary products.[9]

"A great deal has happened over the years," recounts Crail with a twinkle in his eye. "I never imagined that in my search for a place to raise a family things would turn out so sweet!"[10]

Corporate Governance[11]

The biographical sketches for the executive officers and directors as of April 30, 2008, were as follows:

Executive Officers

Franklin E. Crail *(age 66) co-founded the first RMCF store in May 1981. Since the incorporation of the company in November 1982, he has served as its chief executive officer, president, and a director. He was elected chairman of the board in March 1986. Prior to founding the company, Mr. Crail was co-founder and president of CNI Data Processing Inc., a software firm that developed automated billing systems for the cable television industry.*

Bryan J. Merryman *(age 47) joined the company in December 1997 as vice president, Finance, and chief financial officer. Since April 1999, Mr. Merryman has also served the company as chief operating officer and as a director, and since January 2000 as its treasurer. Prior to joining the company, Mr. Merryman was a principal in Knightsbridge Holdings Inc. (a leveraged buyout firm) from January 1997 to December 1997. Mr. Merryman also served as chief financial officer of Super Shops Inc., a retailer and manufacturer of aftermarket auto parts from July 1996 to November 1997, and was employed for more than eleven years by Deloitte and Touche LLP, most recently as a senior manager.*

Gregory L. Pope *(age 41) became senior vice president of Franchise Development and Operations in May 2004. Since joining the company in October 1990, he has served in various positions, including store manager, new store opener, and franchise field consultant. In March 1996 he became director of Franchise Development and Support. In June 2001 he became vice president of Franchise Development, a position he held until he was promoted to his present position.*

Edward L. Dudley *(age 44) joined the company in January 1997 to spearhead the company's newly formed Product Sales Development function as vice president, sales and Marketing, with the goal of increasing the company's factory and retail sales. He was promoted to senior vice president in June 2001. During his 10-year career with Baxter Healthcare Corporation, Mr. Dudley served in a number of senior marketing and sales management capacities, including most recently that of director, Distribution Services from March 1996 to January 1997.*

William K. Jobson *(age 52) joined the company in July 1998 as director of information technology. In June 2001, he was promoted to chief information officer, a position created to enhance the company's strategic focus on information and information technology. From 1995 to 1998, Mr. Jobson worked for ADAC Laboratories in Durango, Colorado, a leading provider of diagnostic imaging and information systems solutions in the healthcare industry, as manager of technical services, and before that, regional manager.*

Jay B. Haws *(age 58) joined the company in August 1991 as vice president of Creative Services. Since 1981, Mr. Haws had been closely associated with the company, both as a franchisee and marketing/graphic design consultant. From 1986 to 1991 he operated two RMCF franchises located in San Francisco. From 1983 to 1989 he served as vice president of Marketing for Image Group Inc., a marketing communications firm based in Northern California. Concurrently, Mr. Haws was co-owner of two other RMCF franchises located in Sacramento and Walnut Creek, California. From 1973 to 1983 he was principal of Jay Haws and Associates, an advertising and graphic design agency.*

Virginia M. Perez *(age 70) joined the company in June 1996 and has served as the company's corporate secretary since February, 1997. From 1992 until joining the company, she was employed by Huettig & Schromm Inc., a property management and development firm in Palo Alto, California, as executive assistant to the president and owner. Huettig & Schromm developed, owned, and managed over 1,000,000 square feet of office space in business parks and office buildings on the San Francisco peninsula. Ms. Perez is a paralegal and has held various administrative positions during her career, including executive assistant to the chairman and owner of Sunset Magazine & Books Inc.*

Directors

The company bylaws provided for no fewer than three or more than nine directors. The board had previously fixed the number of directors at six. Directors were elected for one-year terms. Crail and Merryman were the only two internal board members. Directors of Rocky Mountain Chocolate Factory who did not also serve as an executive officer were as follows:

Gerald A. Kien *(age 75) became a director in August 1995. He retired in 1995 from his positions as president and chief executive officer of Remote Sensing Technologies Inc., a subsidiary of Envirotest Systems Inc., a company engaged in the development of instrumentation for vehicle emissions testing located in Tucson, Arizona. Mr. Kien has served as a director and as chairman*

of the Executive Committee of Sun Electric Corporation since 1980 and as chairman, president, and chief executive officer of Sun Electric until retirement in 1993.

Lee N. Mortenson *(age 71) has served on the board of directors of the company since 1987. Mr. Mortenson has been engaged in consulting and investments activities since July 2000, and was a managing director of Kensington Partners LLC (a private investment firm) from June 2001 to April 2006. Mr. Mortenson has been president and chief executive officer of Newell Resources LLC since 2002, providing management consulting and investment services. Mr. Mortenson served as president, chief operating officer, and a director of Telco Capital Corporation of Chicago, Illinois, from January 1984 to February 2000. Telco Capital Corporation was principally engaged in the manufacturing and real estate businesses. He was president, chief operating officer, and a director of Sunstates Corporation from December 1990 to February 2000. Sunstates Corporation was a company primarily engaged in real estate development and manufacturing. Mr. Mortenson was a director of Alba-Waldensian Inc. from 1984 to July 1999, and served as its president, chief executive officer, and director from February 1997 to July 1999. Alba was principally engaged in the manufacturing of apparel and medical products.*

Fred M. Trainor *(age 68) has served as a director of the company since August 1992. Mr. Trainor is the founder, and since 1984 has served as chief executive officer and president of AVCOR Health Care Products Inc., Fort Worth, Texas (a manufacturer and marketer of specialty dressings products). Prior to founding AVCOR Health Care Products Inc. in 1984, Mr. Trainor was a founder, chief executive officer, and president of Tecnol Inc. of Fort Worth, Texas (also a company involved with the health care industry). Before founding Tecnol Inc., Mr. Trainor was with American Hospital Supply Corporation (AHSC) for 13 years in a number of management capacities.*

Clyde W. Engle *(age 64) has served as a director of the company since January 2000. Mr. Engle is chairman of the board of directors and chief executive officer of sunstates corporation and chairman of the board of directors., president and chief executive officer of Lincolnwood Bancorp, Inc. (formerly known as GSC Enterprises, Inc.), a one-bank holding company, and chairman of the board and chief executive officer of its subsidiary, Bank of Lincolnwood.*

The Board of Directors had determined that Klein, Mortensen, Trainor, and Engle were "independent directors" under Nasdaq Rule 4200. Mortenson, Trainor, and Kien served on the Auditing Committee, Compensation Committee, and the Nominating Committee of the company's board of directors.[12]

Directors of RMCF did not receive any compensation for serving on the board. Directors received compensation for serving on board committees, chairing committees, and participating in meetings. Directors who are not also officers or employees of the company were entitled to receive stock option awards.[13]

As of June 28, 2007, there were approximately 6,080,283 shares of common stock outstanding and eligible to vote at the annual meeting. For each share of common stock held, a shareholder was entitled to one vote on all matters voted on at the annual meeting except the election of directors. Shareholders had cumulative voting rights in the election of directors.[14]

Store Concept[15]

RMCF shops were a blend of traditional and contemporary styles. The company sought to establish a fun and inviting atmosphere in all of its locations. Unlike most other confectionary stores, each RMCF shop prepared certain products, including fudge and caramel apples, in the store. Customers could observe store personnel making fudge from start to finish, including the mixing of ingredients in old-fashioned copper kettles and the cooling of the fudge on large granite or marble tables, and were often invited to sample the store's products. RMCF

believed the in-store preparation and aroma of its products enhanced store ambiance, was fun and entertaining for customers, conveyed an image of freshness and homemade quality, and encouraged additional impulse purchases by customers. According to Crail, "We have a great marketing advantage with our unique in-store candy demonstrations. Customers can watch the cook spin a skewered apple in hot caramel or watch fudge being made before their eyes. Of course, everyone gets a sample!"[16]

RMCF stores opened prior to fiscal 2002 had a distinctive country Victorian décor. In fiscal 2002, the company launched its revised store concept, intended specifically for high foot traffic regional shopping malls. This new store concept featured a sleeker and more contemporary design that continued to prominently feature in-store cooking while providing a more up-to-date backdrop for newly redesigned upscale packaging and displays. The company required that all new stores incorporate the revised store design and also required that key elements of the revised concept be incorporated into existing store designs upon renewal of franchise agreements or transfers in store ownership. Through March 31, 2008, 197 stores incorporating the new design had been opened.

The average store size was approximately 1,000 square feet, approximately 650 square feet of which was selling space. Most stores were open seven days a week. Typical hours were 10 a.m. to 9 p.m., Monday through Saturday, and 12 noon to 6 p.m. on Sundays. Store hours in tourist areas may have varied depending upon the tourist season.

RMCF believed that careful selection of store sites was critical to its success, and it considered a number of factors in identifying suitable sites, including tenant mix, visibility, attractiveness, accessibility, level of foot traffic, and occupancy costs. The company believed that the experience of its management team in evaluating potential sites was one of its competitive strengths, and all final site selection had to be approved by senior management. RMCF had established business relationships with most of the major regional and factory outlet center developers in the United States and believed these relationships provided it with the opportunity to take advantage of attractive sites in new and existing real estate environments.

The company established RMCF stores in five primary environments: 1) regional centers, 2) tourist areas, 3) outlet centers, 4) street fronts, and 5) airports and other entertainment-oriented shopping centers. Each of these environments had a number of attractive features, including high levels of foot traffic. The company, over the last several years, has had a particular focus on regional center locations.

Outlet Centers

As of February 29, 2008, there were approximately 110 factory outlet centers in the United States, and there were RMCF stores in approximately 67 (up from 65 in 2007) of these centers in more than 25 states.

Tourist Areas, Street Fronts, and Other Entertainment-Oriented Shopping Centers

As of February 29, 2008, there were approximately 40 (down from 45 in 2007) RMCF stores in locations considered to be tourist areas, including Fisherman's Wharf in San Francisco, and the Riverwalk in San Antonio, Texas. RMCF believed that tourist areas offer high levels of foot traffic, favorable customer spending characteristics, and increase its visibility and name recognition. The company believed that significant opportunities existed to expand into additional tourist areas.

Regional Centers

There were approximately 1,400 regional centers in the United States, and as of February 29, 2008, there were RMCF stores in approximately 95 (down from 100 in 2007) of these centers, including locations in the Mall of America in Bloomington, Minnesota; and Fort Collins, Colorado. Although often providing favorable levels of foot traffic, regional malls typically involved more expensive rent structures and competing food and beverage concepts. The company's new store concept was designed to capitalize on the potential of the regional center environment.

Other[17]

RMCF believed there were a number of other environments that had the characteristics necessary for the successful operation of successful stores, such as airports and sports arenas. In February 2008, twelve (up from nine in 2007) franchised RMCF stores existed at airport locations: two at both Denver and Atlanta international airports, one each at Charlotte, Minneapolis, Salt Lake City, and Dallas/Fort Worth international airports, one at Phoenix Sky Harbor Airport, and three in Canadian airports, including Edmonton, Toronto Pearson, and Vancouver international airports.

On July 20, 2007, RMCF entered into an exclusive Airport Franchise Development Agreement (which expires on July 20, 2009) with The Grove Inc. The company believed this agreement would accelerate the opening of stores in high volume airport locations throughout the United States. The Grove Inc. was a privately owned retailer of natural snacks and other branded food products and, at the time of the agreement, owned and operated 65 food and beverage units, including retail stores in 13 airports throughout the United States. Under the terms of this agreement, The Grove Inc. had the exclusive right to open RMCF stores in all airports in the United States where there were no stores currently operating or under development. The Grove Inc., as of March 31, 2008, operated three stores under this agreement.

Kiosk Concept

In fiscal 2002, RMCF opened its first full-service retail kiosk to display and sell the company's products. As of March 31, 2008, there were 18 (down from 24 in 2007) kiosks in operation. Kiosks ranged from 150 to 250 square feet and incorporated the company's trademark cooking area where popular confections are prepared in front of customers. The kiosk also included the company's core product and gifting lines in order to provide the customer with a full RMCF experience.

RMCF believed kiosks were a vehicle for retail environments where real estate is unavailable or building costs and/or rent factors do not meet the company's financial criteria. The company also believed the kiosk concept enhanced its franchise opportunities by providing more flexibility in support of existing franchisees' expansion programs and allowed new franchisees that otherwise would not qualify for a store location, an opportunity to join the RMCF system.

Franchising Program

The RMCF franchising philosophy was one of service and commitment to its franchise system, and the company continuously sought to improve its franchise support services. The company's franchise concept had consistently been rated as an outstanding franchise opportunity and in January 2008, RMCF was rated the number one franchise opportunity in the candy category by *Entrepreneur* magazine. As of March 31, 2008, there were 329 franchised stores in the RMCF system.

RMCF believed the visibility of its stores and the high foot traffic at many of its locations had generated strong name recognition of and demand for its providers and franchises. RMCF stores had historically been concentrated in the western and Rocky Mountain regions of the United States, but new stores were gradually being opened in the eastern half of the country.

RMCF's continued growth and success was dependent on both its ability to obtain suitable sites at reasonable occupancy costs for both franchised stores and kiosks and its ability to attract, retain, and contract with qualified franchisees who were devoted to promoting and developing the RMCF store concept, reputation, and product quality. RMCF had established criteria to evaluate prospective franchisees, which included the applicant's net worth and liquidity, together with an assessment of work ethic and personality compatibility with the company's operating philosophy. The majority of new franchises were awarded to persons referred by existing franchisees, to interested consumers who had visited RMCF stores, and to existing franchisees. The company also advertised for new franchisees in national and regional newspapers as suitable store locations were recognized.

Prior to store opening, each domestic franchise owner/operator and each store manager for a domestic franchisee was required to complete a seven-day comprehensive training program in store operations and management at its training center in Durango, Colorado, which included a full-sized replica of a properly configured and merchandised RMCF store. Topics covered in the training course included the company's philosophy of store operation and management, customer service, merchandising, pricing, cooking, inventory and cost control, quality standards, record keeping, labor scheduling, and personnel management. Training was based on standard operating policies and procedures contained in an operations manual provided to all franchisees, which the franchisee was required to follow by terms of the franchise agreement. Additionally, trainees were provided with a complete orientation to company operations by working in key factory operational areas and by meeting with members of the senior management.

Ongoing support was provided to franchisees through communications and regular site visits by field consultants who audited performance, provided advice, and ensured that operations were running smoothly, effectively, and according to the standards set by the company.

The franchisee agreement required compliance with RMCF's procedures of operation and food quality specifications, permitted audits and inspections by the company, and required franchisees to remodel stores to conform to established standards. RMCF had the right to terminate any franchise agreement for non-compliance with operating standards. Franchisees were generally granted exclusive territory with respect to the operation of RMCF stores only in the immediate vicinity of their stores. Products sold at the stores and ingredients used in the preparation of products approved for on-site preparation were required to be purchased from the company or from approved suppliers. Franchise agreements could be terminated upon the failure of the franchisee to comply with the conditions of the agreement or upon the occurrence of certain events, which in the judgment of the company was likely to adversely affect the RMCF system. The agreements prohibited the transfer or assignment of any interest in the franchise without the prior written consent of the company and also gave RMCF the right of first refusal to purchase any interest in a franchise.

The term of each RMCF franchise agreement was 10 years, and franchisees had the right to renew for one additional 10-year term. The company did not provide prospective franchisees with financing for their stores, but had developed relationships with sources of franchisee financing to which it would refer franchisees.

In fiscal 1992, the company entered into a franchise development agreement covering Canada with Immaculate Confections Ltd. of Vancouver, BC. Under this agreement Immaculate Confections had exclusive rights to franchise and operate RMCF stores in Canada. Immaculate Confections, as of March 31, 2008, operated 38 stores under this agreement.

In fiscal 2000, RMCF entered into a franchise development agreement covering the Gulf Cooperation Council States of United Arab Emirates, Qatar, Bahrain, Saudi Arabia, Kuwait, and Oman with Al Muhairy Group of United Arab Emirates. This agreement gave the

Al Muhairy Group the exclusive right to franchise and operate RMCF stores in the Gulf Co-operation Council States. Al Muhairy Group, as of March 31, 2008, operated three stores under this agreement.

Frank Crail gives credit for the success of RMCF to the more than 200 independent franchise operators that bought into his concept. "They are the ones that really make this company a success,"[18] he remarked.

Company-Owned Stores

As of March 31, 2008, there were five company-owned RMCF stores. These stores provided a training ground for company-owned store personnel and district managers and a controllable testing ground for new products and promotions, operating, and training methods and merchandising techniques, which might then be incorporated into the franchise store operations.

The cornerstone of RMCF's growth strategy was to aggressively pursue unit growth opportunities in locations where the company had traditionally been successful, to pursue new and developing real estate environments for franchisees that appeared promising based on early sales results, and to improve and expand the retail store concept, such that previously untapped and unfeasible environments (such as most regional centers) generated sufficient revenue to support a successful RMCF location.[19]

Exhibit 1 shows the total number of RMCF stores in operation as well as those sold but not open as of February 29, 2008.

Company-owned and franchised stores were subject to licensing and regulation by the health, sanitation, safety, building, and fire agencies in the state or municipality where they were located as well as various federal agencies that regulate the manufacturing, packaging, and distribution of food products. RMCF was also subject to regulation by the Federal Trade Commission and must comply with state laws governing the fair treatment of franchisees including the offer, sale, and termination of franchises and the refusal to renew franchises.[20]

Products[21]

RMCF typically produced approximately 300 chocolate candies and other confectionery products at the company's manufacturing facility, using premium ingredients and proprietary recipes developed primarily by its Master Candy Maker. These products included many varieties of nut clusters, caramels, butter creams, mints, and truffles. During the Christmas, Easter, and Valentine's Day holiday seasons, the company may have made as many as 100 additional items, including many candies offered in packages specially designed for the holidays. RMCF continually strove to create and offer new confectionery products in order to maintain the excitement and appeal of its products and to encourage repeat business. RMCF developed a new line of sugar-free and no-sugar-added candies. According to the company, "results have been 'spectacular,' filling a need for those with special dietary requirements."[22]

EXHIBIT 1
Rocky Mountain Chocolate Factory Stores as of February 29, 2008

	Sold, Not Yet Open	Open	Total
Company-Owned Stores		5	5
Franchise Stores—Domestic Stores	14	266	280
Franchise Stores—Domestic Kiosks		18	18
Franchised Stores—International		41	41

SOURCE: *Rocky Mountain Chocolate Factory, Inc. 2008 Form 10-K, p. 34.*

In addition to RMCF's traditional chocolates and candies, special treats were prepared in each store. Besides the caramel-covered apples (some stores feature over 30 varieties), fudge (more than fifteen varieties) was made fresh every day in each store using a marble slab to literally suck the heat out of the confection while the cook shaped it with paddles into a giant 22-pound "loaf." A variety of fruits, nuts, pretzels, and cookies were also dipped by hand in pots of melted milk, dark, and even white chocolate.[23]

One of RMCF's trademarks, big, chunky chocolate concoctions, were created somewhat by accident. According to Crail, "In the early days, my partners and I did not know how to make chocolate and had to literally learn on a ping pong table." Crail recalls that "from the start we made the candy centers too big, not compensating for the added size and weight when coating the pieces in chocolate. And if they didn't look quite right we would dip them again. But the huge pieces instantly caught on and have remained the RMCF benchmark ever since."[24] One of these large-sized specialties was a king-sized peanut butter cup dubbed the Bucket™. Another signature piece, the Bear™ (turtles), was a paw-sized concoction of chewy caramel, roasted nuts and a heavy coating of chocolate. The best-selling items were caramel apples, followed by Bears.[25]

All products were produced consistent with the company's philosophy of using only the finest, highest quality ingredients with no artificial preservatives to achieve its marketing motto of "*the Peak of Perfection in Handmade Chocolates*®."[26]

RMCF believed that, on average, approximately 40 percent of the revenues of RMCF stores were generated by products manufactured at the company's factory, 50% by products made in each store using company recipes and ingredients purchased from the company or approved suppliers, and the remaining 10% by products such as ice cream, coffee, and other sundries purchased from approved suppliers. Franchisees sales of products manufactured by the company's factory generated higher revenue than sales of store-made or other products. A significant decrease in the volume of products franchisees purchase from the company would adversely affect total revenue and the results of operations. Such a decrease could result from franchisees decisions to sell more store-made products or products purchased from third-party suppliers.[27]

Chocolate candies manufactured by the company were sold at prices ranging from $14.90 to $24.00 per pound, with an average price of $18.30 per pound. Franchisees were able to set their own retail prices, though the company recommended prices for all of its products.[28]

Packaging[29]

RMCF developed special packaging for the Christmas, Valentine's Day, and Easter holidays and customers could have their purchases packaged in decorative boxes and fancy tins throughout the year.

In 2002, RMCF completed a project to completely redesign the packaging featured in its retail stores. The new packaging was designed to be more contemporary and capture and convey the freshness, fun, and excitement of the RMCF retail store experience. Sleek, new copper gift boxes were designed to reinforce the association with copper cooking kettles. And the new logo was meant to represent swirling chocolate.[30] This new line of packaging won three National Paperbox Association Gold Awards in 2002, representing the association's highest honors.[31]

Marketing[32]

RMCF sought low-cost, high-return publicity opportunities through participation in local and regional events, sponsorships, and charitable causes. The company had not historically and did not intend to engage in national advertising. RMCF focused primarily on local in-store marketing and promotional efforts by providing customizable marketing materials, including

advertisements, coupons, flyers, and mail-order catalogs generated by its in-house Creative Services Department, and point-of-purchase materials. The Creative Services Department worked directly with franchisees to implement local store marketing programs. To cover its corporate marketing expenses, each franchised store paid a monthly marketing and promotions fee of 1 percent of its monthly gross sales.[33]

The trade name Rocky Mountain Chocolate Factory®, the phrases, The Peak of Perfection in Handmade Chocolates, America's Chocolatier®, The World's Chocolatier®, as well as other trademarks, service marks, symbols, slogans, emblems, logos, and designs used in the Rocky Mountain Chocolate factory system, were proprietary rights of the company. The registration for the trademark "Rocky Mountain Chocolate Factory" had been granted in the United States and Canada. Applications had been filed to register the Rocky Mountain Chocolate Factory trademark in certain foreign countries.[34] The company had not attempted to obtain patent protection for the proprietary recipes developed by the company's Master Candy Maker and was relying upon its ability to maintain confidentiality of those recipes.[35]

Operations and Distribution[36]

Manufacturing

RMCF sought to ensure the freshness of products sold in its stores with frequent shipments to distribution outlets from its 53,000-square-foot manufacturing facility in Durango, Colorado. Franchisees were encouraged to order from the company only the quantities they could reasonably expect to sell within two to four weeks because most stores did not have storage space for extra inventory.

RMCF believed that it should control the manufacturing of its own products in order to better maintain its high product quality standards, offer unique proprietary products, manage costs, control production and shipment schedules, and pursue new or underutilized distribution channels. The company believed its manufacturing expertise and reputation for quality had facilitated the sale of selected products through new distribution channels, including wholesaling, fundraising, corporate sales, mail order, and Internet sales.[37]

RMCF's manufacturing process primarily involved cooking or preparing candy centers, including nuts, caramel, peanut butter, creams and jellies, and then coating them with chocolate or other toppings. All of these processes were conducted in carefully controlled temperature ranges, employing strict quality control procedures at every stage of the manufacturing process. RMCF used a combination of manual and automated processes at its factory. Although RMCF believed that it was preferable to perform certain manufacturing processes, such as dipping some large pieces by hand, automation increased the speed and efficiency of the manufacturing process. The company had from time to time automated processes formerly performed by hand where it had become cost-effective to do so without compromising product quality or appearance. Efforts in the last several years had included the purchase of additional automated factory equipment, implementation of a comprehensive advanced planning and scheduling system, and installation of enhanced point-of-sales systems in all of its company-owned and 182 of its franchised stores through March 31, 2008. These measures had improved the company's ability to deliver its products to the stores safely, quickly, and cost effectively.

Chocolate manufacturing had been a similar process for all companies within the confectionary/chocolate industry up until 2005. In 2005, new chocolate manufacturing technology was introduced. This new manufacturing process, called NETZSCH's ChocoEasy™, enabled chocolate makers of any size to cost-effectively manufacture all varieties of chocolate from scratch. For the first time, smaller chocolate companies were no longer dependant on large chocolate manufacturers and were now free to create their own chocolate recipes and to develop their own proprietary chocolate brands.[38]

During fiscal 2008, the RMCF's manufacturing facility produced approximately 2.84 million pounds of chocolate candies, an increase of 4% from the approximately 2.73 million pounds produced in fiscal 2007. During fiscal 2008 the company conducted a study of factory capacity. As a result of this study, RMCF believed its factory had the capacity to produce approximately 5.3 million pounds per year. In January 1998, the company acquired a two-acre parcel adjacent to its factory to ensure the availability of adequate space to expand the factory as volume demands.[39]

Ingredients[40]

RMCF maintained the taste and quality of its chocolate candies by using only the finest chocolate and other ingredients. The principal ingredients used by RMCF are chocolate, nuts, sugar, corn syrup, cream, and butter. Chocolate was purchased from the Guittard Chocolate company, known for 130 years as providing the finest, most intensely flavored chocolate.[41] The factory received shipments of ingredients daily. To ensure the consistency of its products, ingredients were bought from a limited number of reliable suppliers. The company had one or more alternative sources for all essential ingredients. RMCF also purchased small amounts of finished candy from third parties on a private-label basis for sale in its stores.

Several of the principal ingredients used in RMCF's candies, including chocolate and nuts, were subject to significant price fluctuations. Although cocoa beans, the primary raw material used in the production of chocolate, were grown commercially in Africa, Brazil, and several other countries around the world, cocoa beans were traded in the commodities market, and their supply and price were therefore subject to volatility. RMCF believed its principal chocolate supplier purchased most of its beans at negotiated prices from African growers, often at a premium to commodity prices. RMCF purchased most of its nut meats from domestic suppliers who procured their products from growers around the world. Although the price of chocolate and nut meats had been relatively stable in recent years, the supply and price of nut meats and cocoa beans, and, in turn, chocolate, were affected by many factors, including monetary fluctuations and economic, political, and weather conditions in countries in which both nut meats and cocoa beans were grown.

The Ivory Coast (Cote d'Ivoire) was responsible for producing 40 percent of the world's cocoa beans that are necessary for the manufacturing of chocolate.[42] In late 2006, there was a five-day strike in which laborers refused to enter the factories because of unbearable working conditions. These strikes led to an increase of 20 percent in the price of chocolate for most companies within the industry.[43] Forty-seven percent of the total U.S. imports of cocoa beans came from the Ivory Coast.

RMCF did not engage in commodity futures trading or hedging activities. In order to assure a continuous supply of chocolate and certain nuts, the company entered into purchase contracts of between six to eighteen months for these products. These contracts permitted the company to purchase the specified commodity at a fixed price on an as-needed basis during the term of the contract.

Trucking Operations

Unable to find a suitable shipper, RMCF built its own fleet of brown and bronze semis.[44] In 2008 RMCF operated eight refrigerated trucks and shipped a substantial portion of its products from its factory on its own fleet. The company's trucking operations enabled it to deliver its products to the stores quickly and cost-effectively. In addition, the company back-hauled its own ingredients and supplies, as well as product from third parties to fill available space, on return trips as a basis for increasing trucking program economics.[45] The company's trucking operations are subject to various federal, state, and Canadian provincial regulations.[46]

Human Resources[47]

On February 29, 2008, RMCF employed approximately 190 people. Most employees, with the exception of store, factory, and corporate management, were paid on an hourly basis. RMCF also employed some people on a temporary basis during peak periods of store and factory operations. The company sought to assure that participatory management processes, mutual respect and professionalism, and high performance expectations for the employee existed throughout the organization.

RMCF believed that it provided working conditions, wages, and benefits that compared favorably with those of its competitors. The company's employees were not covered by a collective bargaining agreement. The company considered its employee relations to be good.

Chocolate and Confectionary Industry

While people enjoy chocolate across cultures, there were certain cultures that value chocolate sweets more than others. Per capita consumption of confectionary tended to be the highest in the established markets of Western Europe and North America, although these were also the most mature.[48]

The sale of chocolate and confectionary products was affected by changes in consumer tastes and eating habits, including views regarding the consumption of chocolate. In addition, numerous other factors such as economic conditions, demographic trends, traffic patterns, and weather conditions could influence the sale of confectionary products. Consumer confidence, recessionary and inflationary trends, equity market levels, consumer credit availability, interest rates, consumer disposable income and spending levels, energy prices, job growth, and unemployment rates could impact the volume of customer traffic and level of chocolate and confectionary sales.

According to the National Confectioners Association, the total U.S. candy market approximated $29.1 billion of retail sales in 2007, up from $27.9 in 2005, with chocolate generating sales of approximately $16.3 billion up from $15.7 billion in 2005. Per capita consumption of chocolate in 2006 was approximately 14 pounds per person per year nationally, an increase of 1% when compared to 2005, according to Department of Commerce figures.[49] The average U.S. consumer spent $93.92 on confectionary products in 2006, $52.16 on chocolate.[50] **Exhibit 2** shows 2007 U.S. confectionary market sales.

In 2007 the United States was the strongest market for chocolate. According to a 2004 survey, the U.S. chocolate market was far from being saturated, and considerable opportunities for growth remained, particularly in the gourmet, higher-priced premium segment.[51] Consumers in

EXHIBIT 2
The 2007 U.S. Confectionary Market

	$(in billions)	% change
Retail Sales	$29.1	+3.5%
Manufacturer Shipments	$16.9	+3.0%
Domestic Manufacturer Shipments	$17.5	+2.7%
Imports	$2.2	+4.0%
Exports	$0.9	+13.1%
Profit margin is approximately 35% for the confectionary category.		

SOURCE: *National Confectionary Association 2007 Industry Review on the United States Confectionary Market, January 2008, http://www.ecandy.com/ecandyfiles/2007_Annual_Review_Jan_08.ppt.*

the United States were shifting away from mass-produced chocolates, of the type traditionally manufactured by Hershey Foods and Mars Inc., to more expensive gourmet varieties free from chemicals and preservatives. Hershey and Mars had recognized the trend and had been increasing their interest in premium brands. Some industry observers have predicted that by 2011, premium chocolate will account for 25% of the U.S. market, generating sales of $4.5 billion.[52]

The European chocolate market had also remained lucrative for manufacturers, although there had been some degree of slowdown over the past five years. Average annual per capita chocolate consumption was cited as being about 8 kg in Europe, but this varied considerably country by country.[53] Chocolate was also used for other purposes (baking, snacks, etc.) that differed considerably across ethnic, social, regional, or religious subcultures. **Exhibit 3** shows the leading countries for per capita consumption of chocolate and confectionary.

The leading manufacturers in the European market were Mars, Nestle, Cadbury, Ferrero, and Lindt & Sprungli. These companies saw a bright future in Europe, particularly the markets of the newer members of the EU where consumers had significantly increased their chocolate consumption since 2004. Some manufacturers also believed that Russia was a key market for European growth because its rising affluence had driven a demand for premium chocolate products.[54]

Confectionary manufacturers were also looking to break into new markets such as China and India because of their growing affluence. These markets were dominated by traditional sweets, but there was a growing demand for Western goods, including chocolate, with chocolate consumption increasing at a rate of 25% a year in the Asia-Pacific region and 30% in China.[55] Many large chocolate and confectionary companies had undertaken marketing campaigns in order to lure customers in China, India, and Japan away from traditional sweets to chocolate.[56] **Exhibit 4** shows regional cocoa consumption.

EXHIBIT 3
Per Capita Consumption of Confectionary in Leading Countries in 2002 (in kilograms)

	Chocolate	Sugar	Total
Denmark	8.6	8.0	16.6
Sweden	6.4	9.6	16.0
Ireland	8.8	6.0	14.8
Switzerland	10.7	3.3	14.0
UK	9.3	4.6	13.9
Norway	8.3	4.8	13.1
Germany	7.5	4.9	12.4
Finland	4.8	7.3	12.1
Belgium	8.0	3.5	11.5
Austria	8.2	3.2	11.4

SOURCE: *Leatherheadfood International, The Global Confectionary Market—Trends and Innovations. www.leatherheadfood.com/pdf/confectionary/pdf.*

EXHIBIT 4
Regional Cocoa Consumption

Region	Percentage of global total
Europe	42.8%
Americas	25.9%
Asia and Oceania	17.0%
Africa	14.3%

SOURCE: *Kermani, Faiz, Chocolate Challenges, Report Buyer, 2007, p. 4. www.reportbuyer.com.*

Consumer Tastes and Trends

The growth in the chocolate market was heavily dependent on manufacturers satisfying consumer tastes and being aware of consumer trends in each market in which they operated. In established markets, pressure was coming from consumers for lower-fat healthier snacks and higher quality chocolate. In addition, consumers had been showing an interest in the health-related benefits of chocolate. In emerging markets, chocolate manufacturers have had to compete with traditional confectionary products. In addition, consumers were increasingly becoming concerned with the exploitation of African workers and many were choosing not to do business with "unethical" organizations that were not engaged in fair trade practices.

Gourmet Chocolate and Organic Chocolate

According to industry expert Michelle Moran, "Gourmet chocolate is expected to experience delicious growth over the next four years. Indeed, it is expected to become a nearly $1.8 billion market. According to market analysts and manufacturers, consumers are seeking better-quality chocolate at a variety of market levels. Further evidence of this trend is the recent acquisitions of small artisan chocolatiers by large manufacturing powerhouses."[57] Customers have been increasingly willing to pay higher prices for chocolates they felt were healthier; products made with quality ingredients and free from chemicals and preservatives.

In addition to growth in the gourmet segment of the chocolate industry, organic chocolate sales in the United States grew 65% to $120 million in 2006 according to Massachusetts-based Organic Trade Association, with similar growth forecasted for 2007.[58]

Health Consciousness of Consumers

Throughout history many cultures had believed in the medicinal properties of cocoa. Most historians agree that chocolate was first consumed in Central America and some evidence suggest its use by the Mayan civilization as early 500 BCE.[59] Following the Spanish conquest of Mexico, chocolate found its way to Europe in the 1500s. A number of the original European chocolate manufacturers were apothecaries (early chemists) who wanted to take advantage of the reported medicinal properties of cocoa. Dark chocolate is again being touted and researched for its health benefits. Studies have been reported in medical and scientific journals linking chocolate derived antioxidant flavonols and other compounds with the reduction in the risk of dementia, diabetes, heart-attacks, and strokes. In other studies, dark chocolate has shown health benefits such as decreased blood pressure, lower cholesterol levels, and improved sugar metabolism. Much additional research remains to be done before these health benefits can be confirmed.

According to the National Confectioners Association, dark-chocolate sales were up 50% in 2007.[60] Between 2002 and 2006, Hershey reported an 11.2% increase in the sale of dark chocolate. As a result, Hershey had been concentrating almost half of its business in this area.[61] Mars Inc. was thought to be conducting research trying to substantiate the health benefits of chocolate and had discussed partnerships with pharmaceutical companies to develop products from cocoa-derived compounds.[62] Other manufactures had been experimenting with low-fat, sugar-free products and chocolates fortified with minerals, vitamins, antioxidants, and probiotics.

Ethical and Fair Trade Chocolate

Not only were consumers more health conscious and visibly consuming darker and more premium chocolates products, they were also showing concern for the exploitation of cocoa

farmers in Western Africa, particularly the use of child labor and the prices that cocoa farmers were able to charge for their crop.

Many consumers were choosing to support organizations and purchase products from companies that supported both "ethical chocolates" as well as fair trade practices. These companies had reported rising demand for their products as consumer interest in fair trade had grown.[63]

Competitors

The global market for chocolate was highly competitive. With consumer attitudes changing and new markets offering opportunities for growth, chocolate manufacturers faced a number of challenges in keeping ahead of their rivals.

RMCF and its franchisees competed with numerous businesses that offered confectionery products, from large, publically held, global conglomerates to small, private, local businesses. Many of the large competitors had greater name recognition, both domestically and globally, and greater financial, marketing, and other resources than RMCF. In addition, there was intense competition among retailers for prime locations, store personnel, and qualified franchisees.

Large confectionary companies that had traditionally concentrated on mass-produced candies, sought to make inroads into the premium market. For example, in 2005 Hershey Foods acquired two medium-sized gourmet chocolate companies, Scharffen Berger and Joseph Schmidt, for between $46.6 million and $61.1 million.[64] Mars Inc. established its catalog/retail subsidiary, Ethel M Chocolates, in 1981 when billionaire candy maker Forrest Mars developed a chain of chocolate stores in the western U.S., specializing in liquor-filled candies. In 2005 Ethel M's launched an even more premium line of chocolates called ethel's. Ethel's chocolates were available on-line and could be purchased at upscale department stores, including Nieman Marcus, Macy's, and Marshall Fields.[65] Also in 2005, Ethel's Chocolate Lounge was created as a place where sweets lovers could linger on sofas and order hot cocoa and chocolate fondue.

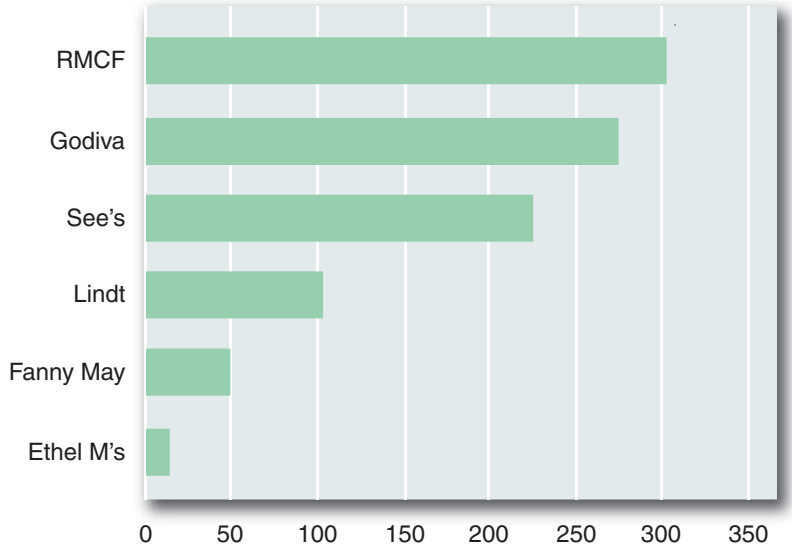
Principal competitors of RMCF included Alpine Confections Inc., Godiva Chocolatier Inc., See's Candies Inc., Chocoladefabriken Lindt & Sprungli AG, Fannie May (a wholly owned subsidiary of Alpine Confections), and Ethel M's/ethel's. These companies not only manufactured chocolate but also had their own retail outlets. **Exhibit 5** shows the number of stores in operation for each of these competitors in 2006.

Godiva Chocolatier, the Belgian chocolate maker, with annual sales of approximately $500 million, was one of the world's leading premium chocolate businesses. Godiva sold its products through company-owned and franchised retail stores, and wholesale distribution outlets, including specialty retailers and finer department stores and on the Internet. In January 2008, Campbell Soup company announced that it agreed to sell its Godiva Chocolatier unit to Yildiz Holdings of Turkey for $850 million. Godiva was to become part of the Ulker Group, which is owned by Yildiz. Ulker is the largest consumer goods company in the Turkish food industry.[66]

Chocoladefabriken Lindt & Sprungli AG and its subsidiaries offered products under multiple brands names, including Lindt, Ghirardelli, Caffarel, Hofbauer, and Kufferle. The company was founded in 1845 and was based in Kilchberg, Switzerland, and had six production sites in Europe, two in the United States, and distribution sites and sales companies on four continents.[67] Lindt & Sprungli was a recognized leader in the market for premium chocolate, and offered a large selection of products in more than 80 countries around the world.[68]

See's Candies, Ethel M's/ethel's, and Alpine Confections Inc. were privately held companies. Alpine Confections Inc. was based in Alpine, Utah, and had sales of approximately $125 million in 2005. Alpine owned a number of candy companies, including Maxfield Candy company, Kencraft Inc., and Harry London Candies Inc. Alpine acquired the Fanny Farmer

EXHIBIT 5
Chocolate Retailers: Number of Stores in Operation 2006



SOURCE: *Prepared by R.J. Falkner & Company Inc. on the company profile report for Rocky Mountain Chocolate Factory, November 15, 2006.*

and Fannie May brands from bankrupt Archibald Candy Corporation in 2004. The company also produced confections under license for Hallmark and Mrs. Fields. Alpine's Canadian brands included Dolce d'Or and Bottecelli, produced in British Columbia.[69]

See's Candies was founded in 1921 and headquartered in San Francisco, and had manufacturing facilities in both Los Angeles and San Francisco. See's Candies was purchased by Berkshire Hathaway Inc. (Warren Buffett) in 1972. The company manufactured over 100 varieties of candies and had over 200 retail candy shops throughout the western United States.[70]

A relatively new competitor founded in Oregon in 1993, acquired by Wayne Zink and Randy Deer in 2005, and moved to Indianapolis, Indiana, was the Endangered Species Chocolate Company. The company was the number-one seller of organic chocolate treats, with annual sales of $16 million in 2007. Its products were stocked at natural-foods stores such as Wild Oats and Whole Foods. Endangered Species Chocolate Co. was committed to making organic and healthy products that were easy on the environment, made with fair-traded ingredients, and with sustainable practices. One of Endangered Species main rivals, Oregon-based Dagoba Chocolate, sold out to Hershey in 2007.[71]

Financial Position[72]

In 2007 RMCF was ranked number 60 in Forbes annual listing of America's 200 Best Small Companies (up from number 124 in 2006). The list was compiled from publically traded companies with sales between $5 million and $750 million. Qualifying candidates were ranked according to return on equity, as well as sustained sales and earnings growth over 12-month and five-year periods.[73] **Exhibits 6 and 7** show the income statements and balance sheets for RMCF for the fiscal years ended 2004 through 2008.

RMCF's revenues were derived from three principal sources: 1) sales to franchisees and others of chocolates and other confectionery products manufactured by the company (75-72-69-68%); 2) sales at company-owned stores of chocolates and other confectionery products including product manufactured by the company (5-8-11-11%); and 3) the collection of initial franchise fees and royalties from franchisees (20-20-20-21%). The figures

EXHIBIT 6
Balance Sheets: Rocky Mountain Chocolate Factory Inc.

Year ending February 28/29	2008	2007	2006	2005	2004
Assets					
Current Assets					
Cash & cash equivalents	$675,642	$2,830,175	$3,489,750	$4,438,876	$4,552,283
Accounts receivable, less allowance for doubtful accounts of $114,271, $187,519, $46,929, $80,641, and $73,630 respectively	3,801,172	3,756,212	3,296,690	2,943,835	2,388,848
Notes receivable	22,435	50,600	116,997	451,845	313,200
Refundable income taxes	63,357			364,630	
Inventories, less reserve for slow moving inventory of $194,719, $147,700, $61,032, $127,345, and $73,269 respectively	4,015,459	3,482,139	2,938,234	2,518,212	2,471,810
Deferred income taxes	117,846	272,871	117,715	156,623	149,304
Other current assets	267,184	367,420	481,091	250,886	353,733
Total current assets	8,963,095	10,759,417	10,440,477	11,124,907	10,229,178
Property and Equipment, Net	5,665,108	5,754,122	6,698,605	6,125,898	5,456,695
Other Assets					
Notes receivable, gross	205,916	310,453	330,746	452,089	649,100
Less: Allowance		0	−52,005	−52,005	−47,005
Notes receivable, net		310,453	278,741	400,084	602,095
Goodwill, net	939,074	939,074	1,133,751	1,133,751	1,133,751
Intangible assets, net	276,247	349,358	402,469	426,827	498,885
Other assets	98,020	343,745	103,438	36,424	16,614
Total other assets	1,519,257	1,942,630	1,918,399	1,997,086	2,281,372
Total Assets	16,147,460	18,456,169	19,057,480	19,247,974	17,967,245
Liabilities and Stockholders' Equity					
Current Liabilities					
Line of Credit	300,000				
Current maturities of long-term debt	-	-		126,000	1,080,400
Accounts payable	1,710,380	898,794	1,145,410	1,088,476	952,542
Accrued salaries & wages	430,498	931,614	507,480	1,160,937	1,091,596
Other accrued expenses	467,543	585,402	750,733	324,215	474,906
Dividends payable	599,473	551,733	504,150	417,090	236,108
Deferred income	303,000	288,500	-	-	-
Total current liabilities	3,810,894	3,256,043	2,907,773	3,116,718	3,835,552
Long-term debt, less current maturities of $126,000 and $1,080,400 respectively				1,539,084	1,986,174
Deferred Income Taxes	681,529	685,613	663,889	698,602	555,567
Stockholders' Equity					
Common stock, $.03 par value; 100,000,000 shares authorized; 100,000,000, 5,980,919, 6,418,905, 4,602,135 and 4,486,461 shares issued and outstanding, respectively	179,428	192,567	188,458	138,064	134, 597
Additional paid-in capital	7,047,142	6,987,558	10,372,530	11,097,208	2,676,222
Retained earnings (accumulated deficit)	4,428,467	7,334,388	4,924,830	2,658,298	8,779,136
Total stockholders' equity	11,655,037	14,514,513	15,485,818	13,893,570	11,589,952
Total liabilities and stockholders' equity	$16,147,460	$18,456,169	$19,057,481	$19,247,891	$17,967,245

SOURCE: *Rocky Mountain Chocolate Factory Inc., 2008 form 10-K, p. 30 and 2005 Form 10-K, p. 30.*

EXHIBIT 7
Statements of Income: Rocky Mountain Chocolate Factory Inc.

Year Ending February 28/29	2008	2007	2006	2005	2004
Revenues					
Sales	$25,558,198	$25,335,739	$22,343,209	$19,380,861	$16,668,210
Franchise & royalty fees	6,319,985	6,237,594	5,730,403	5,142,758	4,464,618
Total revenues	31,878,183	31,573,333	28,073,612	24,523,619	21,132,828
Costs and Expenses					
Cost of sales, exclusive of depreciation and amortization expense of $389,273, $412,546, $381,141, and $359,633, respectively	16,678,472	15,988,620	13,956,550	11,741,205	10,535,352
Franchise costs	1,498,709	1,570,026	1,466,322	1,411,901	1,135,686
Sales & marketing expenses	1,503,224	1,538,476	1,320,979	1,294,702	1,220,585
General & administrative expenses	2,505,676	2,538,667	2,239,109	2,497,718	2,235,499
Retail operating expenses	994,789	1,502,134	1,755,738	1,453,740	1,430,124
Depreciation & amortization	782,951	873,988	875,940	785,083	796,271
Total costs & expenses	23,963,821	24,011,911	21,614,638	19,184,349	17,353,517
Operating Income (loss)	7,914,362	7,561,422	6,458,974	5,339,270	3,779,311
Other Income (Expense)					
Interest expense	(1,566)		(19,652)	(99,988)	(144,787)
Interest income	102,360	67,071	95,360	92,938	93,847
Total other income (expense), net	100,794	67,071	75,708	(7,050)	(50,940)
Income before Income Taxes	8,015,156	7,628,493	6,534,682	5,332,220	3,728,371
Income Tax Expense	3,053,780	2,883,575	2,470,110	2,015,580	1,409,325
Net Income	4,961,376	4,744,918	4,064,572	3,316,640	2,319,046
Basic Earnings per Common Share	0.78	0.74	0.62	0.53	0.38
Diluted Earnings per Common Share	0.76	0.71	0.58	0.49	0.35
Weighted average common shares outstanding	6,341,286	6,432,123	6,581,612	6,307,227	6,146,764
Dilutive effect of employee stock options	159,386	227,350	427,780	498,223	472,205
Weighted average shares outstanding-diluted	6,500,672	6,659,473	7,009,392	6,805,450	6,618,969
Year end shares outstanding	5,980,919	6,418,905	6,596,016	6,442,989	6,281,045
Total number of employees	190	200	235	185	159
Number common of stockholders	400	400	409	420	420
Number of beneficiary stockholders	800	800	800	800	800
Total number of stockholders	1,200	1,200	1,209	1,220	1,220

SOURCE: *Rocky Mountain Chocolate Factory Inc., 2008 Form 10-K, p. 31 and 2005 Form 10-K, p. 29.*

in parentheses show the percentage of total revenues attributable to each source for fiscal years ended February 28 (29), 2008, 2007, 2006, and 2005, respectively.[74]

Basic earnings per share increased 18.5% from fiscal 2006 to fiscal 2007 and from $0.74 in fiscal 2007 to $0.78 in fiscal 2008, an increase of 5.4%. Revenues increased 12.5% from fiscal 2006 to fiscal 2007, and 1% from 2007 to fiscal 2008. Operating income increased 17.1% from fiscal 2006 to fiscal 2007, and 4.7% (from $7.6 million in fiscal 2007 to $7.9 million) in fiscal 2008. Net income increased 16.7% from fiscal 2006 to fiscal 2007, and 4.6% from $4.7 million in fiscal 2007 to $5.0 million in fiscal 2008. The increase in revenue, earnings per share, operating income, and net income in fiscal 2008 compared to fiscal 2007 and 2006 was due primarily to the increased number of franchised stores in operation, the

EXHIBIT 8
Rocky Mountain Chocolate Factory Sources of Revenue 2005–2008 (Revenues in thousands of dollars)

	2008	2007	2006	2005
Factory Sales	$23,758.2	$22,709.0	$19,297.2	$16,654.4
Retail Sales	1,800.0	2,626.7	3,046.0	2,726.4
Royalty and Marketing Fees	5,696.0	5,603.8	5,047.9	4,577.5
Franchise Fees	623.1	633.8	682.5	565.3
Total	$31,877.3	$31,573.3	$28,073.6	$24,523.6

SOURCE: *Rocky Mountain Chocolate Factory, Inc. 2007 Form 10-K, p. 23 and 2006 Form 10-K, p. 20 and 23.*

increased sales to specialty markets, and the corresponding increases in revenue.[75] Details can be found in **Exhibit 8**.

Factory sales increased in fiscal 2008 compared to fiscal 2007 due to an increase of 28.8% in product shipments to specialty markets and growth in the average number of stores in operation to 324 in fiscal 2008 from 310 in fiscal 2007. Same-store pounds purchased in fiscal 2008 were down 9% from fiscal 2007, more than offsetting the increase in the average number of franchised stores in operation and mostly offsetting the increase in specialty market sales. RMCF believed the decrease in same-store pounds purchased in fiscal 2008 was due primarily to a product mix shift from factory products to products made in the stores and also the softening in the retail sector of the economy.[76]

The decrease in retail sales resulted primarily from a decrease in the average number of company-owned stores in operation from 8 in fiscal 2007 to 5 in fiscal 2008. Same-store sales at company-owned stores increased 1.1% from fiscal 2007 to fiscal 2008 and 6.9% from fiscal 2006 to fiscal 2007.[77]

Under the domestic franchise agreement, franchisees paid the company 1) an initial franchise fee; 2) a marketing and promotion fee equal to 1% of the monthly gross retail sales of the franchised store; and 3) a royalty fee based on gross retail sales. RMCF modified its royalty fee structure for any new franchised stores opening the third quarter of fiscal 2004 and later. Under the new structure no royalty was charged on franchised stores' retail sales of products purchased from the company and a 10% royalty was charged on all other sales of product sold at franchised locations. For franchise stores opened prior to the third quarter of fiscal 2004, a 5% royalty fee was charged on franchise stores gross retail sales. Franchise fee revenue was recognized upon opening of the franchise store.[78]

The increase in royalties and marketing fees resulted from growth in the average number of domestic units in operation from 266 in fiscal 2007 to 281 in fiscal 2008 partially offset by a decrease in same store sales of 0.09%. Franchise fee revenues decreased during the past two fiscal years due to a decrease in the number of franchises sold during the same period the previous year.[79]

Cost of sales increased from fiscal 2007 to 2008 due primarily to increased costs and mix of products sold. Company-store margin declined during the same period due primarily to a change in mix of products sold associated with a decrease in the average number of company stores in operation.[80]

As a percentage of total royalty and marketing fee revenue, franchised costs decreased to 23.7% in fiscal 2008, 25.2% in fiscal 2007, and 25.6% in fiscal 2006 due to lower incentive compensation costs. During this same period, sales and marketing costs and general and administrative costs also decreased due primarily to lower incentive compensation costs.[81]

In fiscal 2008 retail operating expenses decreased due primarily to a decrease in the average number of company-owned stores during fiscal 2008 versus fiscal 2007. Retail operating expenses, as a percentage of retail sales, decreased from 57.6% in fiscal 2006, to 57.2% in fiscal 2007, to 55.3% in fiscal 2008 due to a larger decrease in costs relative to the decrease in

revenues associated with a decrease in the average number of company stores in operation during each fiscal year.[82]

Depreciation and amortization of $783,000 in fiscal 2008 decreased 10.4% from the $874,000 incurred in fiscal 2007 due to the sale or closure of four company-owned stores and certain assets becoming fully depreciated. Depreciation and amortization of $874,000 in fiscal 2007 was essentially unchanged from the $876,000 incurred in fiscal 2006.[83]

Other, net of $101,000 realized in fiscal 2008 represented an increase of $34,000 from the $67,000 realized in fiscal 2007, due primarily to higher average outstanding balances of invested cash during fiscal 2008. Notes receivable balances and related interest income declined in fiscal 2008 because of two notes maturing or being paid in full compared with fiscal 2007. RMCF also incurred interest expense in fiscal 2008 related to use of an operating line of credit. Other, net of $67,000 realized in fiscal 2007, represented a decrease of $9,000 from the $76,000 realized in fiscal 2006, due primarily to lower interest income on lower average outstanding balances of notes receivable and invested cash. RMCF paid its long-term debt in full during the first quarter of fiscal 2006.[84]

RMCF's effective income tax rate in fiscal 2008 was 38.1%, which was an increase of 0.3% compared to fiscal 2007. The increase in the effective tax rate was primarily due to increased income in states with higher income tax rates.[85]

In early 2008 RMCF repurchased 391,600 shares of its common stock at an average price of $11.94 because the company believed the stock was undervalued.[86] During the past eight years, the company had repurchased approximately 3,909,000 shares of its common stock (adjusted for stock splits and stock dividends), at an average price of $5.09 per share.[87] As of April 30, 2008, there were 5,980,919 shares of common stock outstanding.[88]

As of February 29, 2008, working capital was $5.2 million compared with $7.5 million as of February 28, 2007. The change in working capital was due primarily to operating results less the payment of $2.4 million in cash dividends and the repurchase and retirement of $5.9 million of the company's common stock.[89]

Cash and cash equivalent balances decreased from $2.8 million as of February 28, 2007, to $676,000 as of February 29, 2008, as a result of cash flows generated by operating and investing activities being less than cash flows used in financing activities. RMCF had a $5.0 million line of credit, of which $4.7 million was available as of February 29, 2008, that bears interest at a variable rate. For fiscal 2009, the company anticipated making capital expenditures of approximately $500,000, which would be used to maintain and improve existing factory and administrative infrastructure and update certain company-owned stores. The company believed that cash flow from operations would be sufficient to fund capital expenditures and working capital requirements for fiscal 2009. If necessary, the company had available bank lines of credit to help meet these requirements.[90]

RMCF revenues and profitability were subject to seasonal fluctuations in sales because of the location of its franchisees, which had traditionally been located in resort or tourist locations. As the company had expanded its geographical diversity to include regional centers, it had seen some moderation to its seasonal sales mix. Historically the strongest sales of the company's products had occurred during the Christmas holiday and summer vacation seasons. Additionally, quarterly results had been, and in the future are likely to be, affected by the timing of new store openings and sales of franchises.[91]

The most important factors in continued growth in the RMCF's earnings were ongoing unit growth, increased same-store sales and increased same-store pounds purchased from the factory. Historically, unit growth more than offset decreases in same-store sales and same-store pounds purchased.[92] RMCF's ability to successfully achieve expansion of its franchise system depended on many factors not within the company's control, including the availability of suitable sites for new store establishment and the availability of qualified franchises to support such expansion.[93]

EXHIBIT 9
Changes in Systemwide Domestic Same-Store Sales

2003	(3.4%)
2004	(0.6%)
2005	4.8%
2006	2.4%
2007	0.3%
2008	(0.9%)

SOURCE: *Rocky Mountain Chocolate Factory, 2008 Form 10-K, p. 4, and 2007 Form 10-K, p. 4.*

For the fiscal year ended February 29, 2008, same-store pounds purchased from the factory by franchised stores decreased 9.1% from the previous fiscal year.[94] Fiscal 2007 showed a similar trend with same-store pounds purchased by franchisees decreasing 2.6% from fiscal 2006.[95] RMCF believed the decrease in same-store pounds purchased was due to a product mix shift from factory-made products to products made in the store, such as caramel apples and fudge.[96] Company efforts to reverse the decline in same-store pounds purchased from the factory by franchised stores and to increase total factory sales depended on many factors, including new store openings, competition, and the receptivity of the company's franchise system to new product introductions and promotional programs.

In addition to efforts to increase the purchases by franchisees of company manufactured products, RMCF was also sought to increase profitability of its store system through increasing overall sales at existing store locations. Changes in systemwide domestic same-store sales can be found in **Exhibit 9**. The company believed that the negative trend in fiscal 2008 was due to the overall weakening of the economy and retail environment.[97]

According to Bryan Merryman, COO and CFO, "Sales at most RMCF stores are greatly influenced by the levels of 'foot traffic' in regional shopping malls and other retail environments where the stores are located, and widely reported declines in such traffic resulted in lower revenues and earnings in the fourth quarter of our 2008 fiscal year. In light of the significant uncertainties surrounding the U.S. economy and retail trends in coming months, combined with decreasing same-store pounds purchased by franchisees, we do not feel comfortable providing specific earnings guidance for fiscal 2009 at the present time. If recent economic and consumer trends continue but do not deteriorate further, we are likely to report a modest decline in earnings for the (2009) fiscal year. Fortunately, we believe we are in excellent financial position and well able to withstand the recessionary forces currently buffeting the U.S. economy."[98]

NOTES

1. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, p. 1, www.boj.com/success/Rocky/Rocky/htm, Rocky Mountain Chocolate Factory Inc., 2008 Form 10-K, p. 3, and Rocky Mountain Chocolate Factory, Inc., www.referenceforbusiness.com//history/Qu-Ro/Rocky–Mountain-Chocolate-Factory, January 28, 2008, pp. 1–6. These sections were directly quoted with minor editing.
2. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, p. 1, www.boj.com/success/Rocky/Rocky/htm.
3. Rocky Mountain Chocolate Factory, Inc., www.referenceforbusiness.com//history/Qu-Ro/Rocky–Mountain-Chocolate-Factory, January 28, 2008, p. 2.
4. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, p. 1, www.boj.com/success/Rocky/Rocky/htm.
5. Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, p. 3.
6. Ibid., p. 30.
7. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, p. 1, www.boj.com/success/Rocky/Rocky/htm.
8. Ibid.
9. Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, p. 10. This section was directly quoted with minor editing.
10. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, p. 2, www.boj.com/success/Rocky/Rocky/htm. This section was directly quoted with minor editing.
11. Rocky Mountain Chocolate Factory, Inc., Proxy Statement, August 17, 2007, pp. 3–4, and Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, pp. 11–12. These sections were directly quoted with minor editing.

12. Rocky Mountain Chocolate Factory, Inc., Proxy Statement, August 17, 2007, p. 11. This section was directly quoted with minor editing.
13. Ibid., p. 20. This section was directly quoted with minor editing.
14. Ibid., p. 1. This section was directly quoted with minor editing.
15. Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, pp. 4–9 and 2007 Form 10-K, pp. 5–7. These sections were directly quoted with minor editing.
16. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, www.boj.com/success/Rocky/Rocky/htm, p.1. This section was directly quoted with minor editing.
17. Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, pp. 7–8 and Rocky Mountain Chocolate Factory, Inc., Press Release, August 1, 2007, p. 1. These sections were directly quoted with minor editing.
18. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, www.boj.com/success/Rocky/Rocky/htm, p. 1.
19. Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, p. 5. This section was directly quoted with minor editing.
20. Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, p.13. This section was directly quoted with minor editing.
21. Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, p. 6. This section was directly quoted with minor editing.
22. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, www.boj.com/success/Rocky/Rocky/htm, p. 2.
23. Rocky Mtn. Chocolate Profiles in Success, January 28, 2008, www.boj.com/success/Rocky/Rocky/htm, p. 2.
24. Ibid., p. 1. This section was directly quoted with minor editing.
25. Rocky Mountain Chocolate Factory, Inc., www.referenceforbusiness.com//history/Qu-Ro/Rocky–Mountain-Chocolate-Factory, January 28, 2008, p.3. This section was directly quoted with minor editing.
26. Rocky Mountain Chocolate Factory, Inc., 2008 Form 10-K, p. 9. This section was directly quoted with minor editing.
27. Ibid., p. 14. This section was directly quoted with minor editing.
28. Ibid., p. 6. This section was directly quoted with minor editing.
29. Ibid., pp. 4, 6. This section was directly quoted with minor editing.
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CASE 27

Dollar General Corporation: 2011 Growth Expansion Plans (Mini Case)

Kathryn E. Wheelen

Expansion Plan

On January 6, 2011, the management of Dollar General announced its 2011 expansion plan for the company. Dollar General had plans to open 625 stores, add 6,000 employees, and open stores in three additional states—Connecticut, Nevada, and New Hampshire. Recently, the company announced plans to open stores in Colorado. In addition, the company intended to remodel or relocate 550 of its 9,200 stores in 35 states.

Each store averaged 6 to 10 employees, a combination of full-time and part-time employees. Employees had the option of flex-time. Wages were competitive to the local market wages. The company had 79,800 employees.[1]

Industry

The dollar discount store industry's primary competitors were Dollar General, the largest company, with revenues of $12.73 billion; Family Dollar Stores, with revenues of $8.04 billion; Dollar Tree in third place with revenues of $5.71 billion. The industry's total revenue was $36.98 billion.[2] See **Exhibit 1** for information on each of the three major players in this industry segment.

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EXHIBIT 1
Direct Competitors of Dollar General (Data is trading 12 months)

A. Dollar Discount Stores' Competitive Information

	Dollar General	Family Dollar	Dollar Tree
Net Sales (millions)	$12,735	$8,041	$5,716
YoY Chg	8.00%	7.6%	13.0%
3-Year CAGR	10.3%	5.1%	10.3%
Comparable sales Chg	5.8%	5.9%	7.1%
Gross margin	32.0%	35.7%	35.3%
Operating margin	9.0%	7.3%	10.3%
Profit margin	3.9%	4.5%	6.5%
Operating income (millions)	$1,145	$588	$590
YoY Chg (in bps)	27.6%	23.8%	7.1%
Net income (millions)	$493	$365	$370
YoY Chg	47.4%	21.8%	27.2%
3-YR GAGR	N/A	14.9%	21.9%
Diluted EPS	$1.43	$2.72	$2.84
YoY Chg	36.2%	27.1%	33.1%
3-YR CAGR	N/A	18.6%	27.6%
Store count	9,273	6,852	4,009
Retail selling Sq. Ft	66,270,000	48,721,000	34,400,000
Employees	79,800	50,000	54,480

B. Average Sales

	Dollar General	Family Dollar	Dollar Tree
Avg. sales/selling sq. ft	$198	$167	$172
Avg. sales/stores (1,000s)	$1,408	$1,189	$1,464
Avg. sales/employee	$155,758	$162,116	$172,671

SOURCE: *http://seekingalpha.com/article/245097-discount-retail-throwdown-a-closer-look-at-dollar-stores?source=yahoo.* Used by permission of the author, Josh Ramer of RetailSails.com

The discount variety store industry's prime player was Wal-Mart with revenues of $419.24 billion, 2,100,000 employees, and income of $15.11 billion. Wal-Mart operated "803 discount stores, 2,747 supercenters, 158 neighborhood markets, and 596 Sam's Clubs in the United States; 43 units in Argentina, 434 in Brazil, 317 in Canada, 252 in Chile, 170 in Costa Rica, 77 in El Salvador, 164 in Guatemala, 53 in Honduras, 1 in India, 371 in Japan, 1,469 in Mexico, 55 in Nicaragua, 56 in Puerto Rico, and 371 in the United Kingdom, as well as 279 stores in the Peoples Republic of China."

Target was in second place with revenues of $66.91 billion, 351,000 employees, and net income of $2.82 billion. It operated 1,746 stores in 49 states. Other large discount store companies were Costco Wholesale Corporation and Kmart Corporation.[3]

Corporate Ownership

KKR (Koldberg Kravis Roberts & Co. L.P) owned 79.17% (7,898,796,886 shares) of the company stock on September 30, 2010. On March 12, 2007, KKR acquired Dollar General for $732 billion. KKR, a private equity company, paid a 31% premium for the stock at $16.78. Goldman Sachs Group Inc. owned 17.17% (1,712,829,454 shares) of the company's stock. Combined, these two companies owned 96.37% of Dollar General's stock.

Goldman Sachs was KKR's advisor on this deal, while Lazard and Lehman Brothers were Dollar General's advisor on this deal.[4]

Management Perspective on Growth

Management's stated position on growth as a strategy is cited as follows:

> *In 2008, management engaged Nielson to assist us in updating our proprietary customer research in an effort to better understand our customers, their purchasing habits and preferences. The results of this study indicate that our highest frequency and highest spending customers, comprising approximately 50% of our sales, are those for whom low prices and value are critical to their everyday shopping decisions. In August of 2009, we updated this study with a customer survey designed to give us insight into recent changes in our customer base. The results of this survey indicate that, while the description of our core customer remains the same, our stores are now attracting customers who had not shopped at our stores previously because of their perception of image or quality. In addition, the percentage of shoppers classified as one-stop shoppers has increased. We believe that recent additions to our merchandise offering, improvements to store operations and expansion of operating hours, along with our consistent value proposition, are resonating well with our existing customers and have been critical to our success in attracting and retaining new customers. Based on additional proprietary survey results, management believes that in excess of 95% of our current customers expect to shop our stores with the same or greater frequency after the economy improves.*
>
> *Based on Nielson Homescan Panel's estimate of Dollar General shoppers, only 41% of the population in our trade area, defined as the countries in which we have stores, has shopped at Dollar General in the past year. We believe that the remaining 59% represents an opportunity to grow our customer base. We are striving to continue to improve on the quality, selection and pricing of our merchandise and upgrade our stores' standards in order to attract and retain increasing numbers and demographics of customers.*[5]

Analyst Views on Dollar General's Expansion

An analyst said, "(this announced 2011 expansion) . . . is in the face of the street's perception lately that Dollar General and the other dollar stores have had their day. The Street's view is that Dollar General and the others will lose the middle income customers they've gained as the economy continues to grow stronger."[6]

The analyst further stated, "(third quarter) . . . declining growth rate is interpreted on the Street as a trend that will continue. However, investors with a longer-term view might see the same news with different eyes."[7]

Another analyst said, "The dollar stores have included more national brands in their merchandise in a move to retain the new higher income customer and keep them coming back long after the recession has passed." He further stated, "Also, in a development the (Wall) Street dismissed, higher inflation on some of the dollar store merchandise is leading to . . . (lower store margins)."[8]

Anthony Chukunba, BB&T analyst, said, "Even though the economy is starting to recover, consumers will continue to look for ways to save money." Management of Dollar General would agree with this analyst. The management also feels the company's enhanced merchandise with more national brands at a lower cost was a strong magnet to draw customers into their store.[9]

An analyst said the crucial factor in the present depressed economy was the hiring of employees with wages to support a family, and not jobs at minimum wages and no health care. If the former occurs, this plays into the customers who will shop at Dollar General.

According to the Federal Reserve Chairman, Ben S. Bernanke, wages in 2010 increased only 1.7%. The country needed to add 230,000 jobs just to keep up with the growth in the

yearly population (college and high school graduates, etc.). If inflation returned to the economy, wages must exceed the annual wage increase so consumers would have more money to spend.

The U.S unemployment rate in January, 2011 was around 9.4%–9.6%. The actual total unemployment rate was 16.6%.[10]

The Dollar General Store and Merchandise

The average Dollar General store had approximately 7,100 square feet of selling space and was typically operated by a manager, an assistant manager, and three or more sales clerks. Approximately 55% of the stores were in freestanding buildings, 43% in strip shopping centers, and 2% in downtown buildings. Most of its customers lived within three miles, or a 10-minute drive, of the stores. The Dollar General store strategy featured low initial capital expenditures, limited maintenance capital, low occupancy and operating costs, and a focused merchandise offering within a broad range of categories, allowing the company to deliver low retail prices while generating strong cash flows and investment returns. A typical new store in 2009 required approximately $230,000 of equipment, fixtures, and initial inventory, net of payables.

Dollar General generally had not encountered difficulty locating suitable store sites in the past. Given the size of the communities that it was targeting, Dollar General believed that there was ample opportunity for new store growth in existing and new markets. In addition, the current real estate market was providing an opportunity for Dollar General to access higher quality sites at lower rates than in recent years. Also, Dollar General believed it had significant opportunities available for its relocation and remodel programs. Remodeled stores required approximately $65,000 for equipment and fixtures while the cost of relocations was approximately $110,000 for equipment, fixtures, and additional inventory, net of payables. Dollar General has increased the combined number of remodeled and relocated stores to 450 in 2009 as compared to 404 in 2008 and 300 in 2007.[11]

The following chart shows the Dollar General's four major categories of merchandise:[12]

	2009	2008	2007
Consumables	70.8%	69.3%	66.5%
Seasonal	14.5%	14.6%	15.9%
Home products	7.4%	8.2%	9.2%
Apparel	7.3%	7.9%	8.4%

Finance

Exhibit 2 shows the consolidated balance sheets and **Exhibit 3** shows the consolidated statements of income for Dollar General. The key financial metrics shown below were developed by management for 2010.[13]

Management recognized that the company had *substantial debt*, which included a $1.964 billion senior secured term loan facility which matures on July 6, 2014; $979.3 million aggregate principal amount of 10.623% senior notes due 2015; and $450.7 million aggregate principal amount of 11.875%/12.625% senior subordinated toggle notes due 2017. This debt could have important negative consequences to the business, including:

- Same-store sales growth;
- Sales per square floor;
- Gross profit, as a percentage of sales;

EXHIBIT 2
Dollar General Corporation and Subsidiaries Consolidated Balance Sheets *(In thousands, except per share amounts)*

	January 28, 2011	January 29, 2010
Assets		
Current assets:		
Cash and cash equivalents	$ 497,446	$ 222,076
Merchandise inventories	1,765,433	1,519,578
Income taxes receivable	–	7,543
Prepaid expenses and other current assets	104,946	96,252
Total current assets	2,367,825	1,845,449
Net property and equipment	1,524,575	1,328,386
Goodwill	4,338,589	4,338,589
Intangible assets, net	1,256,922	1,284,283
Other assets, net	58,311	66,812
Total assets	$ 9,546,222	$ 8,863,519
Liabilities and Shareholders' Equity		
Current liabilities:		
Current portion of long-term obligations	$ 1,157	$ 3,671
Accounts payable	953,641	830,953
Accrued expenses and other	347,741	342,290
Income taxes payable	25,980	4,525
Deferred income taxes payable	36,854	25,061
Total current liabilities	1,365,373	1,206,500
Long-term obligations	3,287,070	3,399,715
Deferred income taxes payable	598,565	546,172
Other liabilities	231,582	302,348
Commitments and contingencies		
Redeemable common stock	9,153	18,486
Shareholders' equity:		
Preferred stock, 1,000 shares authorized	–	–
Common stock; $0.875 par value, 1,000,000 shares authorized, 341,507 and 340,586 shares issued and outstanding at January 28, 2011 and January 29, 2010, respectively	298,819	298,013
Additional paid-in capital	2,945,024	2,293,377
Retained earnings	830,932	203,075
Accumulated other comprehensive loss	(20,296)	(34,167)
Total shareholders' equity	4,054,479	3,390,298
Total liabilities and shareholders' equity	$ 9,546,222	$ 8,863,519

SOURCE: *Dollar General Corporation, 2010 Form 10-K, p. 64.*

EXHIBIT 3
Dollar General Corporation and Subsidiaries Consolidated Statements of Income *(In thousands, except per share amounts)*

	For the Year Ended		
	January 28, 2011	**January 29, 2010**	**January 30, 2009**
Net sales	$ 13,035,000	$ 11,796,380	$ 10,457,668
Cost of goods sold	8,858,444	8,106,509	7,396,571
Gross profit	4,176,556	3,689,871	3,061,097
Selling, general and administrative expenses	2,902,491	2,736,613	2,448,611
Litigation settlement and related costs, net	—	—	32,000
Operating profit	1,274,065	953,258	580,486
Interest income	(220)	(144)	(3,061)
Interest expense	274,212	345,744	391,932
Other (income) expense	15,101	55,542	(2,788)
Income before income taxes	984,972	552,116	194,403
Income tax expense	357,115	212,674	86,221
Net income	$ 627,857	$ 339,442	$ 108,182
Earnings per share:			
Basic	$ 1.84	$ 1.05	$ 0.34
Diluted	$ 1.82	$ 1.04	$ 0.34
Weighted average shares:			
Basic	341,047	322,778	317,024
Diluted	344,800	324,836	317,503

SOURCE: *Dollar General Corporation, 2010 Form 10-K, p. 65.*

- Operating profit;
- Inventory turnover;
- Cash flow;
- Net income;
- Earnings per share;
- Earnings before interest, income taxes, depreciation, and amortization; and
- Return on invested capital.

Management's position on the impact of debt on the company was stated below:

- Increasing the difficulty of our ability to make payments on our outstanding debt;
- Increasing our vulnerability to general economic and industry conditions because our debt payment obligations may limit our ability to use our cash to respond to our cash flow to fund our operations, capital expenditures, and future business opportunities or pay dividends;
- Limiting our ability to obtain additional financing for working capital expenditures, debt service requirements, acquisitions, and general corporate or other purposes;
- Placing us at a disadvantage compared to our competitors who are less highly leveraged and may be better able to use their cash flow to fund competitive response to changing industry, market, or economic conditions.[14]

NOTES

1. Greg Stushinisu, "Dollar General Forges Ahead," January 20, 2011, and company announcement on January 6, 2011 and company documents.
2. Yahoo–Finance–competitors of Dollar General.
3. Yahoo–Finance–for both Wal-Mart and Target.
4. Parla B. Kavilana, "Dollar General to Be Acquired by KKR," *CNNMoney.com*, March 12, 2007.
5. Dollar General Corporation, "SEC 10-K," January 29, 2010, p. 8. These two paragraphs are directly quoted.
6. Greg Stushinisu, "Dollar General Forges Ahead," January 20, 2011 (posted).
7. Ibid.
8. Ibid.
9. Ibid.
10. CNN Finance and MSNBC—both had Chairman Bernanke on the news.
11. Dollar General Corporation, "SEC 10-K," January 29, 2010, p.7. These two paragraphs are directly quoted.
12. Ibid.
13. Ibid., p. 11.
14. Ibid., p. 31.

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CASE 28

Inner-City Paint Corporation (Revised)

Donald F. Kuratko and Norman J. Gierlasinski

History

Stanley Walsh began Inner-City Paint Corporation in a run-down warehouse, which he rented, on the fringe of Chicago's "downtown" business area. The company is still located at its original site.

Inner-City is a small company that manufactures wall paint. It does not compete with giants such as Glidden and DuPont. There are small paint manufacturers in Chicago that supply the immediate area. The proliferation of paint manufacturers is due to the fact that the weight of the product (52½ pounds per 5-gallon container) makes the cost of shipping great distances prohibitive. Inner-City's chief product is flat white wall paint sold in 5-gallon plastic cans. It also produces colors on request in 55-gallon containers.

The primary market of Inner-City is the small- to medium-sized decorating company. Pricing must be competitive; until recently, Inner-City had shown steady growth in this market. The slowdown in the housing market combined with a slowdown in the overall economy caused financial difficulty for Inner-City Paint Corporation. Inner-City's reputation had been built on fast service: it frequently supplied paint to contractors within 24 hours. Speedy delivery to customers became difficult when Inner-City was required to pay cash on delivery (C.O.D.) for its raw materials.

Inner-City had been operating without management controls or financial controls. It had grown from a very small two-person company with sales of $60,000 annually five years ago, to sales of $1,800,000 and 38 employees this year. Stanley Walsh realized that tighter controls within his organization would be necessary if the company was to survive.

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Equipment

Five mixers are used in the manufacturing process. Three large mixers can produce a maximum of 400 gallons, per batch, per mixer. The two smaller mixers can produce a maximum of 100 gallons, per batch, per mixer.

Two lift trucks are used for moving raw materials. The materials are packed in 100-pound bags. The lift trucks also move finished goods, which are stacked on pallets.

A small testing lab ensures the quality of materials received and the consistent quality of their finished product. The equipment in the lab is sufficient to handle the current volume of product manufactured.

Transportation equipment consists of two 24-foot delivery trucks and two vans. This small fleet is more than sufficient because many customers pick up their orders to save delivery costs.

Facilities

Inner-City performs all operations from one building consisting of 16,400 square feet. The majority of the space is devoted to manufacturing and storage; only 850 square feet is assigned as office space. The building is 45 years old and in disrepair. It is being leased in three-year increments. The current monthly rent on this lease is $2,700. The rent is low in consideration of the poor condition of the building and its undesirable location in a run-down neighborhood (south side of Chicago). These conditions are suitable to Inner-City because of the dusty, dirty nature of the manufacturing process and the small contribution of the rent to overhead costs.

Product

Flat white paint is made with pigment (titanium dioxide and silicates), vehicle (resin), and water. The water makes up 72% of the contents of the product. To produce a color, the necessary pigment is added to the flat white paint. The pigment used to produce the color has been previously tested in the lab to ensure consistent quality of texture. Essentially, the process is the mixing of powders with water, then tapping off of the result into 5- or 55-gallon containers. Color overruns are tapped off into 2-gallon containers.

Inventory records are not kept. The warehouse manager keeps a mental count of what is in stock. He documents (on a lined yellow pad) what has been shipped for the day and to whom. That list is given to the billing clerk at the end of each day.

The cost of the materials to produce flat white paint is $2.40 per gallon. The cost per gallon for colors is approximately 40% to 50% higher. The 5-gallon covered plastic pails cost Inner-City $1.72 each. The 55-gallon drums (with lids) are $8.35 each (see **Exhibit 1**).

EXHIBIT 1
Paint Cost Sheet: Inner-City Paint Corporation

	5 Gallons	55 Gallons
Sales price	$27.45	$182.75
Direct material	(12.00)	(132.00)
Pail and lid	(1.72)	(8.35)
Direct labor	(2.50)	(13.75)
Manufacturing overhead ($1/gallon)	(5.00)	(5.00)
Gross margin	$6.23	$23.65
Gross profit ratio	22.7%	12.9%

Selling price varies with the quantity purchased. To the average customer, flat white sells at $27.45 for 5 gallons and $182.75 for 55 gallons. Colors vary in selling price because of the variety in pigment cost and quantity ordered. Customers purchase on credit and usually pay their invoices in 30 to 60 days. Inner-City telephones the customer after 60 days of nonpayment and inquires when payment will be made.

Management

The President and majority stockholder is Stanley Walsh. He began his career as a house painter and advanced to become a painter for a large decorating company. Walsh painted mostly walls in large commercial buildings and hospitals. Eventually, he came to believe that he could produce a paint that was less expensive and of higher quality than what was being used. A keen desire to open his own business resulted in the creation of Inner-City Paint Corporation.

Walsh manages the corporation today in much the same way that he did when the business began. He personally must open *all* the mail, approve *all* payments, and inspect *all* customer billings before they are mailed. He has been unable to detach himself from any detail of the operation and cannot properly delegate authority. As the company has grown, the time element alone has aggravated the situation. Frequently, these tasks are performed days after transactions occur and mail is received.

The office is managed by Mary Walsh (Walsh's mother). Two part-time clerks assist her, and all records are processed manually.

The plant is managed by a man in his twenties, whom Walsh hired from one of his customers. Walsh became acquainted with him when the man picked up paint from Inner-City for his previous employer. Prior to the eight months he has been employed by Walsh as Plant Manager, his only other experience has been that of a painter.

Employees

Thirty-five employees (20 workers are part-time) work in various phases of the manufacturing process. The employees are nonunion, and most are unskilled laborers. They take turns making paint and driving the delivery trucks.

Stanley Walsh does all of the sales work and public relations work. He spends approximately one half of every day making sales calls and answering complaints about defective paint. He is the only salesman. Other salesmen had been employed in the past, but Walsh felt that they "could not be trusted."

Customer Perception

Customers view Inner-City as a company that provides fast service and negotiates on price and payment out of desperation. Walsh is seen as a disorganized man who may not be able to keep Inner-City afloat much longer. Paint contractors are reluctant to give Inner-City large orders out of fear that the paint may not be ready on a continuous, reliable basis. Larger orders usually go to larger companies that have demonstrated their reliability and solvency.

Rumors abound that Inner-City is in difficult financial straits, that it is unable to pay suppliers, and that it owes a considerable sum for payment on back taxes. All of the above contribute to the customers' serious lack of confidence in the corporation.

Financial Structure

Exhibits 2 and **3** are the most current financial statements for Inner-City Paint Corporation. They have been prepared by the company's accounting service. No audit has been performed because Walsh did not want to incur the expense it would have required.

EXHIBIT 2
Balance Sheet for the Current Year Ending June 30: Inner-City Paint Corporation

Current assets		
Cash	$1,535	
Accounts receivable (net of allowance for bad debts of $63,400)	242,320	
Inventory	18,660	
Total current assets		$262,515
Machinery and transportation equipment	47,550	
Less accumulated depreciation	15,500	
Net fixed assets		32,050
Total assets		$294,565
Current liabilities		
Accounts payable	$217,820	
Salaries payable	22,480	
Notes payable	6,220	
Taxes payable	38,510	
Total current liabilities		$285,030
Long-term notes payable		15,000
Owners' equity		
Common stock, no par, 1,824 shares outstanding		12,400
Deficit		(17,865)
Total liabilities and owners' equity		$294,565

EXHIBIT 3
Income Statement for the Current Year Ending June 30: Inner-City Paint Corporation

Sales		$1,784,080
Cost of goods sold		1,428,730
Gross margin		$355,350
Selling expenses	$72,460	
Administrative expenses	67,280	
President's salary	132,000	
Office Manager's salary	66,000	
Total expenses		337,740
Net income		$17,610

Future

Stanley Walsh wishes to improve the financial situation and reputation of Inner-City Paint Corporation. He is considering the purchase of a computer to organize the business and reduce needless paperwork. He has read about consultants who are able to quickly spot problems in businesses, but he will not spend more than $300 on such a consultant.

The solution that Walsh favors most is one that requires him to borrow money from the bank, which he will then use to pay his current bills. He feels that as soon as business conditions improve, he will be able to pay back the loans. He believes that the problems Inner-City is experiencing are due to the overall poor economy and are only temporary.

CASE 29

The Carey Plant

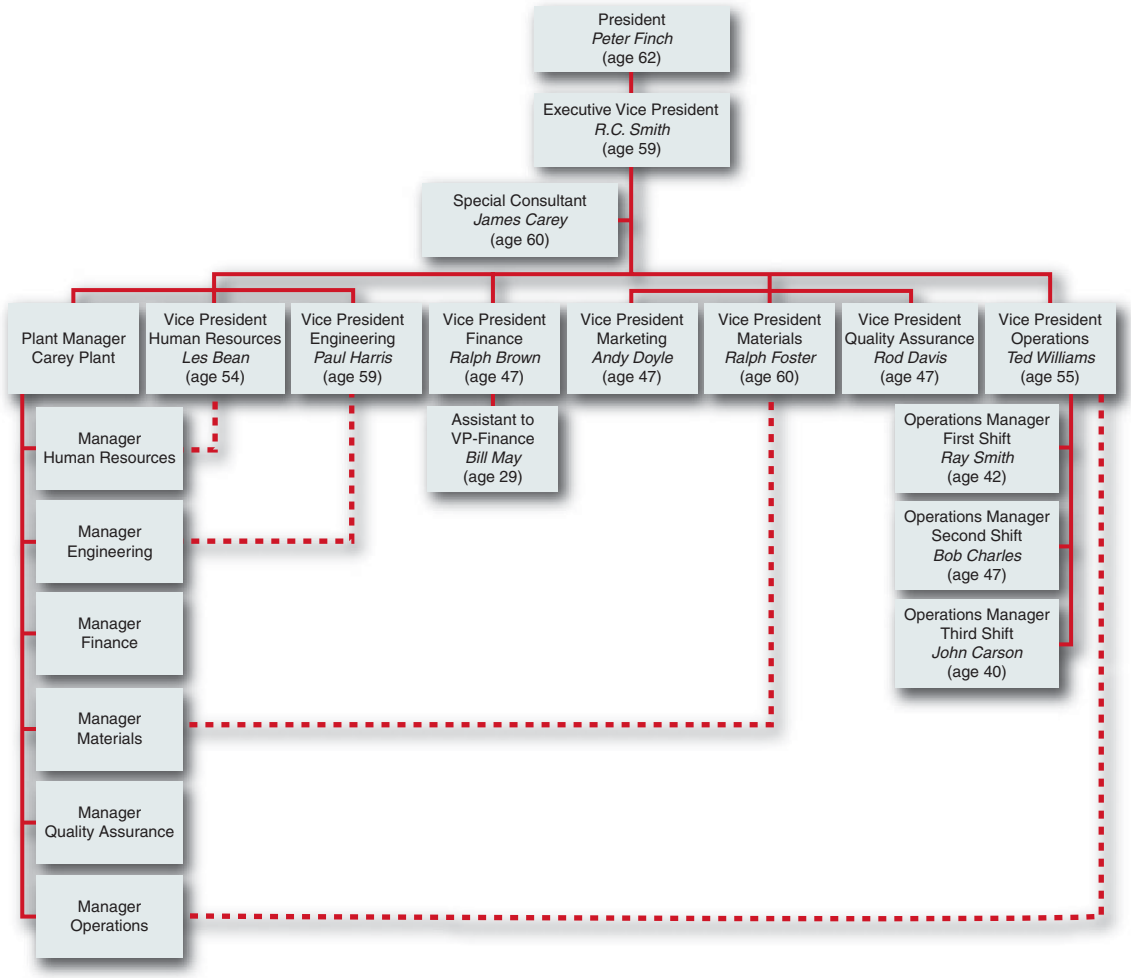
Thomas L. Wheelen and J. David Hunger

THE GARDNER COMPANY WAS A RESPECTED NEW ENGLAND MANUFACTURER OF MACHINES and machine tools purchased by furniture makers for use in their manufacturing process. As a means of growing the firm, the Gardner Company acquired Carey Manufacturing three years ago from James Carey for $3,500,000. Carey Manufacturing was a high quality maker of specialized machine parts. Ralph Brown, Gardner's Vice President of Finance, had been the driving force behind the acquisition. Except for Andy Doyle and Rod Davis, all of Gardner's Vice Presidents (**Exhibit 1**) had been opposed to expansion through acquisition. They preferred internal growth for Gardner because they felt that the company would be more able to control both the rate and direction of its growth. Nevertheless, since both Peter Finch, President, and R. C. Smith, Executive Vice President, agreed with Brown's strong recommendation, Carey Manufacturing was acquired. Its primary asset was an aging manufacturing plant located 400 miles away from the Gardner Company's current headquarters and manufacturing facility. The Gardner Company was known for its manufacturing competency. Management hoped to add value to its new acquisition by transferring Gardner's manufacturing skills to the Carey Plant through significant process improvements.

James Carey, previous owner of Carey Manufacturing, agreed to continue serving as Plant Manager of what was now called the Carey Plant. He reported directly to the Gardner Company Executive Vice President, R. C. Smith. All functional activities of Carey Manufacturing had remained the same after the acquisition, except for sales activities being moved under Andy Doyle, Gardner's Vice President of Marketing. The five Carey Manufacturing salesmen were retained and allowed to keep their same sales territories. They exclusively sold only products made in the Carey Plant. The other Carey Plant functional departments (Human Resources, Engineering, Finance, Materials, Quality Assurance, and Operations) were supervised by Managers who directly reported to the Carey Plant Manager. The Managers of the Human Resources, Engineering, Materials, and Operations Departments also reported indirectly (shown by dotted lines in **Exhibit 1**) to the Vice Presidents in charge of their respective function at Gardner Company headquarters.

This case was prepared by Professor Thomas L. Wheelen and J. David Hunger of Iowa State University. Names and dates in the case have been disguised. An earlier version of this case was presented to the 2000 annual meeting of the North American Case Research Association. This case may not be reproduced in any form without written permission of the two copyright holders, Thomas L. Wheelen and J. David Hunger. This case was edited for *SMBP*–9th, 10th, 11th, 12th, and 13th Editions. Copyright © 2001, 2005, and 2008 by Thomas L. Wheelen and J. David Hunger. The copyright holders are solely responsible for case content. Any other publication of the case (translation any form of electronic or other media) or sale (any form of partnership) to another publisher will be in violation of copyright law, unless Thomas L. Wheelen and J. David Hunger have granted additional written reprint permission. Reprinted by permission.

EXHIBIT 1
Gardner Company Organization Chart



Note: Dotted lines show an indirect reporting relationship.

Until its acquisition, Carey Manufacturing (now the Carey Plant) had been a successful firm with few problems. Following its purchase, however, the plant had been plagued by labor problems, increasing costs, a leveling of sales, and a decline in profits (**Exhibit 2**). Two years ago, the Carey Plant suffered a 10-week strike called by its union in response to demands from the new management (Gardner Company) for increased production without a corresponding increase in pay. (Although Gardner Company was also unionized, its employees were represented by a different union than were the Carey Plant employees.) Concerned by both the strike and the poor performance of the Carey Plant since its purchase two years earlier, Ralph Brown initiated a study last year to identify what was wrong. He discovered that the poor performance of the Carey Plant resulted not only from its outdated and overcrowded manufacturing facility, but also from James Carey's passive role as Plant Manager. Gardner's Executive Committee (composed of the President and eight Vice Presidents) had been aware of the poor condition of the Carey Plant when it had agreed to the acquisition. It had therefore initiated

EXHIBIT 2
Carey Plant: Recent Sales and Profit Figures

Year	Sales	Profits
5 Years Ago	$12,430,002	$697,042
4 Years Ago	13,223,804	778,050
3 Years Ago	14,700,178	836,028
2 Years Ago	10,300,000	(220,000)[1]
Last Year	13,950,000	446,812

Note:

1. Ten-week strike during October, November, and December.

plans to replace the aging plant. A new state-of-the-art manufacturing facility was being built on available property adjacent to the current plant and should be completed within a few months. The information regarding James Carey was, however, quite surprising to the Committee. Before Gardner's purchase of Carey Manufacturing, James Carey had been actively involved in every phase of his company's operations. Since selling the company, however, Carey had delegated the running of the plant to his staff, the Department Managers. One of his Managers admitted that "He was the driving force of the company, but since he sold out, he has withdrawn completely from the management of the plant."

After hearing Brown's report, the Executive Committee decided that the Carey Plant needed a new Plant Manager. Consequently, James Carey was relieved of his duties as Plant Manager in early January this year and appointed special consultant to the Executive Vice President, R. C. Smith. The current staff of the Carey Plant was asked to continue operating the plant until a new Plant Manager could be named. Vice Presidents Brown and Williams were put in charge of finding a new Manager for the Carey Plant. They recommended several internal candidates to the Executive Vice President, R. C. Smith.

The Offer

On January 31 of this year, Smith offered the Plant Manager position of the Carey Plant to Bill May, current Assistant to Ralph Brown. May had spent six years in various specialist capacities within Gardner's Finance Department after being hired with an MBA. He had been in his current position for the past two years. Brown supported the offer to May with praise for his subordinate. "He has outstanding analytical abilities, drive, general administrative skills and is cost conscious. He is the type of man we need at the Carey Plant." The other executives viewed May not only as the company's efficiency expert, but also as a person who would see any job through to completion. Nevertheless, several of the Vice Presidents expressed opposition to placing a staff person in charge of the new plant. They felt the Plant Manager should have a strong technical background and line management experience. Brown, in contrast, stressed the necessity of a control-conscious person to get the new plant underway. Smith agreed that Gardner needed a person with a strong finance background heading the new plant.

Smith offered May the opportunity to visit the Carey Plant to have a private talk with each of his future staff. Each of the six Department Managers had been with the Carey Plant for a minimum of 18 years. They were frank in their discussions of past problems in the plant and in its future prospects. They generally agreed that the plant's labor problems should decline in the new plant, even though it was going to employ the same 405 employees (half the size of Gardner) with the same union. Four of them were concerned, however, with how they were being supervised. Ever since the acquisition by the Gardner Company, the Managers of the Operations, Materials, Human Resources, and Engineering Departments reported not only to James Carey as Plant Manager, but also to their respective functional Vice Presidents and staff

at Gardner headquarters. Suggestions from the various Vice Presidents and staff assistants often conflicted with orders from the Plant Manager. When they confronted James Carey about the situation, he had merely shrugged. Carey told them to expect this sort of thing after an acquisition. "It's important that you get along with your new bosses, since they are the ones who will decide your future in this firm," advised Carey.

Bill May then met in mid-February with Ralph Brown, his current supervisor, to discuss the job offer over morning coffee. Turning to Brown, he said, "I'm worried about this Plant Manager's position. I will be in a whole new environment. I'm a complete stranger to those Department Managers, except for the Finance Manager. I will be the first member of the Gardner Company to be assigned to the Carey Plant. I will be functioning in a line position without any previous experience and no technical background in machine operations. I also honestly feel that several of the Vice Presidents would like to see me fail. I'm not sure if I should accept the job. I have a lot of questions, but I don't know where to get the answers." Looking over his coffee cup as he took a drink, Brown responded, "Bill, this is a great opportunity for you. What's the problem?" Adjusting himself in his chair, May looked directly at his mentor. "The specific details of the offer are very vague in terms of salary, responsibilities, and authority. What is expected of me and when? Do I have to keep the current staff? Do I have to hire future staff members from internal sources or can I go outside the company? Finally, I'm concerned about the lack of an actual job description." Brown was surprised by his protégé's many concerns. "Bill, I'm hoping that all of these questions, except for salary, will soon be answered at a meeting Smith is scheduling for you tomorrow with the Vice Presidents. He wants it to be an open forum."

The Meeting

The next morning, May took the elevator to the third floor. As he walked down the hall to the Gardner Company Executive Committee conference room, he bumped into Ted Williams, Vice President of Manufacturing, who was just coming out of his office. Looking at Bill, Ted offered, "I want to let you know that I'm behind you 100%. I wasn't at first, but I do think you may have what it takes to turn that place around. I don't care what the others think." As the two of them entered the conference room, May looked at the eight Gardner Vice Presidents. Some were sitting at the conference table and working on their laptops while others were getting some coffee from the decanter in the corner. R. C. Smith was already seated at the head of the table. Ralph Brown, sitting on one side of the table, motioned to May to come sit in an empty chair beside him. "Want some coffee?" Brown asked. "Good idea," responded May as he walked over to the decanter. Pouring cream into his coffee, May wondered, "What am I getting myself into?"

CASE 30

The Boston Beer Company:

BREWERS OF SAMUEL ADAMS BOSTON LAGER (Mini Case)

Alan N. Hoffman

Company History

The Boston Beer Company was founded by Jim Koch in 1984 after the discovery of his great-great grandfather's family microbrew recipe in the attic of his home in Cincinnati, Ohio. In his kitchen, Jim Koch brewed the first batch of what is today known as Samuel Adams® Boston Lager. Through use of the family recipe, Jim handcrafted a higher quality, more flavorful beer than what was currently available in the United States.

Samuel Adams® beers were known for their distinct taste and freshness. Although different brewers had access to the rare, expensive Noble hops that Samuel Adams® used, its special ingredients remained a secret and were what gave its brews their distinct flavor. Jim Koch refused to compromise on the components that made up the full, rich flavorful taste of Samuel Adams® beer.

As his business began to grow, Jim moved his brewing operations into an old, abandoned brewery in Pennsylvania. This was subsequently followed by the opening of the extremely popular Boston Brewery in 1988. In the mid-1990s, Jim further expanded his business operations by purchasing the Hudepohl-Schoenling Brewery in his hometown of Cincinnati, Ohio. In 1995 The Boston Beer Company Inc. went public.

Jim Koch was viewed as the pioneer of the American craft beer revolution. He founded the largest craft brewery, brewing over 1 million barrels of 25 different styles of Boston Beer products, employing 520 people. Nevertheless, Boston Beer was only the sixth-largest brewer in the United States, producing less than 1% of the total U.S. beer market in 2010.

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Since its inception, Jim Koch has had numerous offers from the large brewing companies to buy him out, but he has consistently declined those offers. He wanted to remain independent and never compromise on the full, rich flavorful and fresh taste of Samuel Adams® beer. Jim never altered his great-great grandfather's original recipe created over a century ago.

Corporate Mission and Vision

The mission of the Boston Beer Company was "to seek long term profitable growth by offering the highest quality products to the U.S. beer drinker."[1] As the largest craft brewer, the Boston Beer Company had been successful for several reasons: (1) premium products produced from the highest quality ingredients; (2) an unwavering commitment to the freshness of its beer; (3) constant creativity and innovation that resulted in the introduction of a new flavor of beer every year; and (4) the passion and dedication of its employees.

The Boston Beer Company's vision was "to become the leading brewer in the Better Beer category by creating and offering high quality full-flavored beers."[2] The Better Beer category was comprised of craft brewers, specialty beers, and a large majority of the imports. As of 2010, Samuel Adams® was the largest craft brewer and "the third largest brand in the Better Beer category of the United States brewing industry, trailing only the imports Corona and Heineken."[3]

In 2007, the Boston Beer Company had revenues of $341 million with COGS of $152 million and $22.5 million of net income. From 2007 to 2009, revenues grew by 22% to $415 million with COGS of $201 million and $31.1 million in net income. Management expected sales to be $430 million in 2010. The Boston Beer Company had no long-term debt and only 14 million shares outstanding. In August 2010, the stock price was $67.

The Beer Industry

The domestic beer market in 2010 was facing many challenges. In 2010, domestic beer overall sales declined 1.2%. Industry analysts predicted inflation-adjusted growth to be only 0.8% through 2012.[4] Decreases in domestic beer sales as a whole were mainly due to decreased alcohol consumption per person. U.S. consumers were drinking less beer because of health concerns, increased awareness of the legal consequences of alcohol abuse, and an increase in options for more flavorful wines and spirits.

To gain more market share in a highly competitive market, the industry was shifting to the mass production of beers, leading to industry consolidation. There were two major players in the brewing industry in the United States: AB InBev (Anheuser-Busch) and SABMiller PLC (SABMiller). SABMiller PLC was a 2007 joint venture of SABMiller and Molson Coors. Anheuser-Busch had been purchased in 2008 by Belgium producer InBev, the second largest beer producer in the world.

The domestic beer industry also contained some opportunities. Although sales of domestic beer were flat, the past decade showed increases in the domestic consumption of light beer and the craft beer categories. The Better Beer category (comprised of craft, specialty, and import beers) was growing at an annual rate of 2.5% and comprised roughly 19% of all U.S. sales. Beers were classified as "better beers" mainly because of higher quality, taste, price, and image, compared to mass-produced domestic beers. The craft beer segment grew an estimated 9% in 2010. In an industry dominated by male customers, females were viewed as an opportunity. Research showed that women were most concerned about the calories in beer. However, 28% of these same women answered that they were presently drinking more wine.[5]

The growth in craft beer sales was good news for the Boston Beer Company, which positioned itself in this category and was the largest and most successful craft brewer in the United States. It ranked third overall in the U.S. Better Beer category, trailing only two imports: Corona from Mexico and Heineken from The Netherlands.

Domestic Beers

Two major players in the U.S. domestic beer market—AB InBev and MillerCoors—accounted for roughly 95% of all U.S. beer production and sales, minus imports.

MillerCoors LLC controlled roughly 30% of the U.S. beer market. MillerCoors recently entered the Better Beer category by acquiring, in whole or in part, existing craft brewers and by importing and distributing foreign brewers' brands. In 2010, the company experienced double-digit growth with its Blue Moon, Leinenkugel's, and Peroni Nastro Azzurro brands.

AB Inbev was the number one brewer in the U.S. market in terms of both volume and revenues. Its dominant position allowed it to exert significant influence over distributors, making it difficult for smaller brewers to maintain their market presence or access new markets. Inbev was created in the 2004 merger of the Belgian company Interbrew and the Brazilian brewer AmBev and subsequently purchased Anheuser-Busch in 2008.

Craft Beer Segment

Sierra Nevada Brewing Company was the second largest craft beer maker in the United States. Founded in Chico, California, in 1980, the company's mission was to produce the finest quality beers and ales, and believed that its mission could be accomplished "without compromising its role as a good corporate citizen and environmental steward." Its most successful brands included the hop-flavored Pale Ale, as well as Porter, Stout, and wheat varieties. Sierra Nevada, like Samuel Adams®, produced seasonal brews including Summer Fest, Celebration, and Big Foot. Although Sierra Nevada beer had been distributed nationally for some time, sales were still strongest on the West Coast.

New Belgium Brewing Company was founded in 1991 in Fort Collins, Colorado. Its Fat Tire brand made up two-thirds of the company's total sales.[6] New Belgium currently had nine total craft beer brands, in addition to seasonal and limited brands. Its products were offered in 25 western and midwestern states. New Belgium, like Sierra Nevada, focused on being eco-friendly and stressed employee ownership in its mission.

Imports

Grupo Modelo was founded in 1925 and was the market leader in Mexico. Its most successful product, Corona Extra, was the United States' number one beer import out of 450 imported beers. AB Inbev held a 50% noncontrolling interest in Grupo Modelo.

Heineken, the third largest brewer by revenue, positioned itself as the world's most valuable international premium beer. Heineken had over 170 international, regional, and local specialty beers and 115 breweries in 65 countries. It had the widest presence of all international brewers due to the sales of Heineken and Amstel products.

Flavored Malt Beverage Category

Samuel Adams® also competed in the "flavored malt beverage" (FMB) category with Twisted Tea. The FMB category accounted for roughly 2% of U.S. alcohol consumption. Twisted Tea competed mainly with beverages such as Smirnoff Ice, Bacardi Silver, and Mike's Hard Lemonade. FMB products all targeted relatively the same consumers. Since pricing was similar, these products relied heavily upon advertising and promotions.

Current Challenges

The Boston Beer Company had been growing revenues by 22% over the past two years, and the craft beer industry as a whole continued to experience double-digit growth as well. However, there were some challenges ahead if the company was to successfully achieve its mission and continue this level of growth.

1. Probably the most critical challenge was the increased level of competition in the craft beer industry. "Volume sales within the craft beer industry increased 20% during 2002–2010 to 220 million cases,"[7] and this astonishing growth attracted many players into this market, especially imported beers such as Corona and Heineken, and the top two brewers AB Inbev and MillerCoors.
2. Through mergers and acquisitions, the major competitors achieved cost savings and greater leverage with suppliers and distributors and preferential shelf space and placement with retailers.
3. A continuous increase in production costs of all basic beer ingredients, such as barley malt and hops, as well as packaging materials like glass, cardboard, and aluminum continued into 2010 with further increases in fuel and transportation costs. The global inventory of the company's "Noble" hops declined, and the harvest in recent years of its two key hops suppliers in Germany did not meet the high standards of the Boston Beer Company. As a result, Boston Beer received a lower quantity at a higher price than expected.
4. The company purchased a brewery in Breinigsville, Pennsylvania, in 2008 for $55 million. Although this brewery was expected to increase capacity by 1.6 million barrels of beer annually, it required significant renovations before it could produce quality beer.

United Airlines Dilemma

United Airlines recently approached the Boston Beer Company with an interesting opportunity. United wanted to offer Samuel Adams® Boston Lager to fliers on all of its flights. This would provide the Boston Beer Company increased national exposure and could result in a significant increase in beer sales. However, United Airlines would only sell Samuel Adams® Boston Lager in cans, not bottles.

The Boston Beer Company had never sold any of its beers in cans because management believed that metal detracts from the flavor of the beer. Management felt that the "full-flavor" of Samuel Adams® could only be realized using glass bottles. Should Boston Beer's management rethink its decision not to distribute its beer in cans to take advantage of this opportunity? Many years ago, Jim Koch said that there would never be a "Sam Adams Light Beer," but he eventually reversed that decision and Sam Light became a huge success.

NOTES

1. 2007 Annual Report, http://thomson.mobular.net/thomson/7/2705/3248/.
2. 2007 Annual Report, http://thomson.mobular.net/thomson/7/2705/3248/.
3. 2007 Annual Report, http://thomson.mobular.net/thomson/7/2705/3248/.
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6. http://www.rockymountainnews.com/news/2007/nov/24/reuteman-colorado-rides-on-fat-tire-to-beer/.
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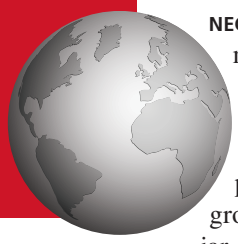
CASE 31

Wal-Mart and Vlasic Pickles

Karen A. Berger



PATRICK HUNN SAT AT HIS DESK WONDERING HOW COULD SUCH A GOOD DEAL BE VIEWED NEGATIVELY? Patrick Hunn, team leader of Wal-Mart Sales, for Vlasic Foods International, had made a record-breaking deal with Wal-Mart that resulted in selling more pickles than Vlasic had ever sold to any one account. Wal-Mart was an important customer, accounting for 30% of Vlasic Foods' sales. By negotiating a deal with Wal-Mart to offer a gallon jar of Vlasic pickles for $2.97 at the front of the store, Hunn had given Wal-Mart its "customer stopper." In addition, Hunn secured an agreement that Wal-Mart would continue to buy grocery size pickles, relishes, and peppers with each order of the gallon jar. The gallon jar of Vlasic pickles was available in over 3,000 Wal-Mart stores in the United States. It had been the deal of a lifetime, he had thought at the time. Why did Marketing conclude that the deal was an enormous mistake even though Vlasic sold more product to Wal-Mart than had ever been sold into any account? Steve Young, vice president of Grocery Marketing for Vlasic Foods International, had approved the deal. Why was Young so convinced now that Vlasic needed to get out as soon as they could?

Background

The Vlasic brand had a long heritage of being the number one pickle brand in America. The founders of the product line were Polish immigrants who sold their pickles through a dairy and food distributor in Detroit. From a creamery business to a full-scale manufacturing operation, the Vlasic brand was built on product quality and strong advertising and promotion. An advertising campaign developed in 1974 featured a stork delivering the message, "Vlasic is the best-tasting pickle I ever heard!" This campaign helped give the brand a national identity.

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In 1978 the company was sold to the Campbell Soup Company. As part of Campbell, the Vlasic brand prospered due to increased investment in both advertising expenditures and R&D. The 1994 roll-out of the Vlasic Stackers line of pickle slices intended for sandwiches continued to help build the brand into a major line of pickle products accounting for over a third of the U.S. pickle market. By 2000 the brand boasted 95% consumer awareness and was the only national pickle brand in America. However, the overall pickle market had been flat for a few years and Vlasic had only achieved small gains in the nineties. As Campbell's reconsidered its own agenda, its stock prices were sagging. Seeking to improve its profitability picture, Campbell reviewed its business units with an eye to weed out those businesses that did not meet Campbell's corporate benchmarks and objectives. Ultimately, the decision was made to spin off several non-core businesses, including Vlasic pickles as well as Open Pit Barbecue Sauce, Swanson foods, Armour meats in Argentina, and a mushroom farm business.

In March 1998 Campbell spun off a newly public company called Vlasic Foods International. This move was seen as essential to change Campbell's strategic focus and improve its long-term financial picture. The newly spun-off company, however, held debt of over $500 million along with an annual sales volume of $1.1 billion. The Vlasic line was its strongest business, accounting for sales of over $251 million in 2000.

Patrick Hunn had a long-established relationship with Wal-Mart. First, he was a major liaison between Sam's Club, a division of Wal-Mart, and Vlasic when it was part of Campbell's. His decade-long relationship with Wal-Mart made him essential to the newly formed company. He was quickly promoted from team leader of Sam's Clubs for Vlasic pickle brands to team leader of Wal-Mart for all Vlasic brands and products.

Both Hunn and Young had access to the Retail Link database that Wal-Mart had made available to its sixty-one thousand U.S. suppliers. From this database, first made accessible to vendors in 1991, Young and other selected executives from Vlasic could look at their sales data to help them understand the source and timing of their brands sold through Wal-Mart. This system helped Vlasic and other companies service Wal-Mart in the way that Wal-Mart wanted, with speed and care. In most stores, the system was connected at the individual store level allowing a given supplier to receive reports of shelf movement via real-time satellite links that update the system report each time a scan occurred at the point-of-purchase. Thus, the supplier was able to adjust its manufacturing qualities in real-time. The accuracy and timeliness of this type of system eliminated warehouse stock pile-ups, saving time and processing costs for the supplier. A supplier that did not have this type of electronic data interchange throughout the supply chain usually had higher costs and, therefore, would be likely to have difficulty meeting Wal-Mart's demands.

Like other Wal-Mart suppliers, Vlasic knew that Wal-Mart did not tolerate late orders or out-of-stocks. Wal-Mart provided the seamlessness for suppliers to maximize the efficiency of the supply chain and they expected their suppliers to respond. Vlasic had had no difficulties meeting Wal-Mart's volume requirements.

Bob Bernstock, president of the newly formed Vlasic Foods, knew that Wal-Mart was essential to his company. By 1998 it was well-established—not just at Vlasic—that a contract with Wal-Mart by definition was very important to a company's growth and success. The scale of business that Wal-Mart promised companies was unprecedented given the size of its orders and distribution capabilities. Wal-Mart was able to go national with a new item in two weeks as compared to two months in many other chains.

Hunn knew that his "charge" was to build volume for Vlasic brands and products through Wal-Mart. He had successfully worked with Wal-Mart and saw this deal as just one more opportunity to do business with this important and well-respected client. While he was not sure that the one gallon deal was a good idea at first, he had warmed up to the notion when he realized he could tie the deal to the "grocery segment," defined as pickles, relishes, and peppers 46 oz. and below.

Major deals and programs had to be approved by the president of Sales, Maurice Lane. Both Steven Young, vice president for grocery sales, and Pat Hunn, team leader for the Wal-Mart account, reported to the president of Sales.

By 1990 Wal-Mart was the number one retailer in the United States. By 1997 Wal-Mart had already had its first $100 billion sales year with combined national and international sales totaling $105 billion. Wal-Mart had become an international company with stores in Canada, Argentina, Korea, China, and Germany. As team leader of Sales for such a large, important account, Pat Hunn was an important player at Vlasic, controlling 30% of its largest line, Vlasic pickles.

The focus on the one-gallon jar of Vlasic pickles came into play when a Wal-Mart manager came up with the idea to offer the one-gallon jar usually sold in the Food Service section as a Memorial Day item at the promotion price of $2.97, instead of the everyday low price of $3.47. The Food Service section, also known as the Institutional section, was an eight-foot section near the rest of the grocery. The Food Service section contained items that small concession businesses and "Mom 'n Pop" grocery stores regularly bought. This section tended to not be as frequently shopped as the end aisles and other more prominent areas of the store. The Wal-Mart manager who wanted to do this promotion called the Bentonville headquarters, requesting promotional dollars for the one-gallon jar. Like other consumer packaged goods companies, Vlasic regularly gave its customers allowance money, part of a Marketing Investment Planning program (MIP fund for short). Once allowance money was paid, Vlasic customers could utilize the funds as they wished. Wal-Mart was a centralized organization with promotional funds controlled at the Wal-Mart headquarters. Thus, the manager of an individual store had to get promotional funding from headquarters.

According to Hunn, the allowance permitted this one Wal-Mart store to price the gallon jar at a price point of $2.97. The promotion ran over Memorial Day and "the gallon sold like crazy. . . . surprising us all."[1] News of this success spread throughout the Wal-Mart district. Soon many managers in the region wanted to duplicate this success in their stores.

In late 1998, one of the Wal-Mart grocery buyers, remembering the success of the Vlasic gallon-jar promotion, brainstormed that the gallon jar could be a "customer stopper." The overwhelming success of this limited market promotion triggered more discussions between Hunn, the Wal-Mart team leader at Vlasic, and the buying department at Wal-Mart. As team leader of the Wal-Mart account, Hunn's position required that he focus on building volume and market share. Approval of the deal needed to also come from Steve Young, vice president of grocery marketing. Both Hunn and Young were eager to build volume for their core brand.

The Deal

According to Hunn, this little promotion in a relatively low trafficked part of the store soon blossomed into a major deal, because of the newly expanded scope of the promotion. Wal-Mart executives were convinced that if consumers were enticed by a gallon of pickles at $2.97 in the Food Service section, then they would be even more enticed if the promotion was moved to an end aisle. In fact, Wal-Mart buyers saw the one-gallon jar as the "customer stopper" they wanted. The product was to be a special feature that was showcased in end stacks near or at the front of the stores. At the agreed upon price of $2.97, the jar would yield only one or two cents per jar for Vlasic. At this lower cost, Wal-Mart could price the jar at $2.97, leaving no more than a few cents profit per gallon jar for Wal-Mart as well. However, Hunn secured the deal with one proviso—all gallon-jar orders would have to be tied to a corresponding order of grocery sized items. As another control measure, the total number of cases that Vlasic would sell to Wal-Mart was established at the start of the fiscal year as part of the normal planning process.

The Results

The sales test proved right—the promotion was an enormous success for Wal-Mart. Vlasic's sales numbers skyrocketed, showing double-digit growth in the first few weeks. The gallon jar was so successful that Wal-Mart was purportedly selling on average 80 jars per store per week, or more than 240,000 gallons of pickles, just counting those sold in the gallon jars. However, the production quantities necessary to serve Wal-Mart put a strain on the procurement and production system. However, the product was selling and the Wal-Mart business grew to more than 30% of Vlasic Food International's business.[2]

Wal-Mart was very pleased with the success of the item. Wal-Mart continued to re-order gallon jars as stock became low. Since there was no cap on the order volume except for the requirement to also purchase the grocery size, the one-gallon jar was no longer a short-lived deal item, but a regular deal. From the consumer's point of view, the $2.97 deal was the Wal-Mart Every Day Low Price.

However, sources at Vlasic reported that profit was down 25%–50%. Some blamed the Wal-Mart deal for this decline. Production was pressed to provide quantities in record numbers and at times put a strain on the supply chain. Since the gallon jar used the same size and generally same product quality cucumbers as the dills and spears, this at times affected the availability of pickles for the jars of dills and spears. Since the jars of dills and spears consisted of cut pickles, they carried higher margins than the whole pickles. In addition, the pickle cost for the gallon jar could be reduced if less perfectly shaped pickles were added to the one gallon jar. However, the expansion of the distribution of the gallon jar resulted in periodic substitutions of the more perfect (and higher cost) pickles intended for the smaller but more profitable jars of dills and spears. Thus, pickles that were needed for the jars of dills and spears were sometimes in short supply and compromised the smooth flow of the supply chain. Marketing reported that over time, the few cents that Vlasic was making on the promotion was eroded, resulting in small losses per jar, given higher costs.

Supermarket sales, in non–Wal-Mart chains and independent stores, in 1999–2000 declined significantly with many customers placing smaller orders than the previous year. Marketing at Vlasic reported that predicted profits were eaten up by expenses associated with the loss of business in the non–Wal-Mart grocery sector.

On the other hand, Wal-Mart business showed real, incremental growth in its stores, based on analysis of organic growth from store expansion versus same-store growth. Not only was Wal-Mart growing due to new stores, but its existing stores were growing and showing healthy revenue and profit gains.

Through this promotion, volume of Vlasic pickles—all kinds—in Wal-Mart stores grew, so that Wal-Mart accounted for 33% of the Vlasic business. According to Hunn, sales revenue of Vlasic pickles was higher than before the gallon-jar "promotion."

The Marketing Perspective

Steve sat at his desk. His hands were full of problems due to cash flow shortages at his company. Vlasic Foods International had been spun off from Campbell's just months ago. The effect of the $500 million of debt that the spun-off company took with it was just becoming known. While this deal was only one issue in a sea of financial challenges, Steve felt that he should weigh in on the Wal-Mart part of the business given its effects on non–Wal-Mart grocery accounts. He had pleaded with Hunn to dip into his equity with Wal-Mart and end this promotion. Young was sure that this promotion had cannibalized the non–Wal-Mart business. According to Young, they "saw consumers who used to buy the spears and the chips in

supermarkets buying the Wal-Mart gallons. They'd eat a quarter of a jar and throw the thing away when they got moldy. A family can't eat them fast enough."[3]

The Sales Perspective

Pat Hunn was surprised, if not disturbed, by the commentary from grocery marketing. Vlasic had financial troubles that went way beyond the sale of pickles. Wal-Mart was a great customer—sales with Wal-Mart now reached 33% of the Vlasic Foods business. On the revenue side, Vlasic's business was up with a dramatic shift upward in Wal-Mart sales. "Yes, there have been some troubles with production, but that was their job. Wal-Mart has helped build Vlasic's name as a leader in the pickle business. . . . I simply do not see why so many people are upset," thought Hunn to himself. He sat at his desk, shrugged his shoulders, and went back to work.

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CASE 32

Panera Bread Company (2010): Still Rising Fortunes?

Joyce P. Vincelette and Ellie A. Fogarty

BREAD—ESSENTIAL AND BASIC, but nonetheless special—has transcended millennia. A master baker combined simple ingredients to create what has been an integral part of society and culture for over 6,000 years. Sourdough bread, a uniquely American creation, was made from a "culture" or "starter." Sourdough starter contained natural yeasts, flour, and water and was the medium that made bread rise. In order to survive, a starter had to be cultured, fed, and tended to by attentive hands in the right environment. Without proper care and maintenance, the yeast, or the growth factor, would slow down and die. Without a strong starter, bread would no longer rise.

Ronald Shaich, CEO and Chairman of Panera Bread Company, created the company's "starter." Shaich, the master baker, combined the ingredients and cultivated the leavening agent that catalyzed the company's phenomenal growth. Under Shaich's guidance, Panera's total systemwide (both company and franchisee) revenues rose from $350.8 million in 2000 to $1,353.5 million in 2009, consisting of $1,153.3 million from company-owned bakery-café sales, $78.4 million from franchise royalties and fees, and $121.9 million from fresh dough sales to franchisees. Franchise-operated bakery-café sales, as reported by franchisees, were $1,640.3 million in fiscal 2009.[1] Panera shares have outperformed every major restaurant stock over the last 10 years.[2] Panera's share price has risen over 1,600% from $3.88 a share on December 31, 1999, to $67.95 a share on December 28, 2009.[3] Along the way, Panera largely led the evolution of what became known as the "fast casual" restaurant category.

Ronald Shaich had clearly nurtured the company's "starter" and had been the vision and driving force behind Panera's success from the company's beginnings until his resignation as CEO and Chairman effective May 13, 2010. For Panera to continue to rise, the company's new CEO, William Moreton, would need to continue to feed and maintain Panera's "starter." In addition to new unit growth, new strategies and initiatives must be folded into the mix.

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History

Panera Bread grew out of the company that could be considered the grandfather of the fast casual concept: Au Bon Pain. In 1976, French oven manufacturer Pavailler opened the first Au Bon Pain (a French colloquialism for "where good bread is") in Boston's Faneuil Hall as a demonstration bakery. Struck by its growth potential, Louis Kane, a veteran venture capitalist, purchased the business in 1978.[4] Between 1978 and 1981, Au Bon Pain opened 13, and subsequently closed 10, stores in the Boston area and piled up $3 million in debt.[5] Kane was ready to declare bankruptcy when he gained a new business partner in Ronald Shaich.[6]

Shortly after opening the Cookie Jar bakery in Cambridge, Massachusetts, in 1980, Shaich, a recent Harvard Business graduate, befriended Louis Kane. Shaich was interested in adding bread and croissants to his menu to stimulate morning sales. He recalled that "50,000 people a day were going past my store, and I had nothing to sell them in the morning."[7] In February 1981, the two merged the Au Bon Pain bakeries and the cookie store to form one business, Au Bon Pain Co. Inc. The two served as co-CEOs until Kane's retirement in 1994. They had a synergistic relationship that made Au Bon Pain successful: Shaich was the hard-driving, analytical strategist focused on operations, and Kane was the seasoned businessperson with a wealth of real estate and finance connections.[8] Between 1981 and 1984, the team expanded the business, worked to decrease the company's debt, and centralized facilities for dough production.[9]

In 1985, the partners added sandwiches to bolster daytime sales as they noticed a pattern in customer behavior: "We had all of these customers coming and ordering a baguette cut in half. Then they'd take out these lunch bags full of cold cuts and start making sandwiches. We didn't have to be marketing whizzes to know that there was an opportunity there," recalled Shaich.[10] It was a "eureka" moment, and the birth of the fast casual restaurant category.[11] According to Shaich, Au Bon Pain was the "first place that gave white collar folks a choice between fast food and fine dining."[12] Au Bon Pain became a lunchtime alternative for urban dwellers who were tired of burgers and fast food. Differentiated from other fast-food competitors by its commitment to fresh, quality sandwiches, bread, and coffee, Au Bon Pain attracted customers who were happy to pay more money ($5 per sandwich) than they would have paid for fast food.[13]

In 1991, Kane and Shaich took the company public. By that time, the company had $68 million in sales and was a leader in the quick service bakery segment. By 1994, the company had 200 stores and $183 million in sales, but that growth masked a problem. The company was built on a limited growth concept, what Shaich called, "high density urban feeding."[14] The main customers of the company were office workers in locations like New York, Boston, and Washington DC. The real estate in such areas was expensive and hard to come by. This strategic factor limited expansion possibilities.[15]

Au Bon Pain acquired the Saint Louis Bread Company in 1993 for $24 million. Shaich saw this as the company's "gateway into the suburban marketplace."[16] The acquired company, founded in 1987 by Ken Rosenthal, consisted of a 19-store bakery-café chain located in the Saint Louis, Missouri, area. The concept of the café was based on San Francisco sourdough bread bakeries. The acquired company would eventually become the platform for what is now Panera.

Au Bon Pain management spent two years studying Saint Louis Bread Co., looking for the ideal concept that would unite Au Bon Pain's operational abilities and quality food with the broader suburban growth appeal of Saint Louis Bread. The management team understood that a growing number of consumers wanted a unique expression of tastes and styles, and were tired of the commoditization of fast-food service. Shaich and his team wrote a manifesto that spelled out what Saint Louis Bread would be, from the type of food it would serve, to the kind of people behind the counters, and to the look and feel of the physical space.[17]

Au Bon Pain began pouring capital into the chain when Shaich had another "eureka" moment in 1995. He entered a Saint Louis Bread store and noticed a group of business people meeting in a corner. The customers explained that they had no other place to talk.[18] This experience helped Shaich realize that the potential of the neighborhood bakery-café concept was greater than that of Au Bon Pain's urban store concept. The bakery-café concept capitalized on a confluence of current trends: the welcoming atmosphere of coffee shops, the food of sandwich shops, and the quick service of fast food.[19]

While Au Bon Pain was focusing on making Saint Louis Bread a viable national brand, the company's namesake unit was faltering. Rapid expansion of its urban outlets had resulted in operational problems, bad real estate deals,[20] debt over $65 million,[21] and declining operating margins.[22] Stiff competition from bagel shops and coffee chains such as Starbucks compounded operational difficulties. Au Bon Pain's fast-food ambiance was not appealing to customers who wanted to sit and enjoy a meal or a cup of coffee. At the same time, the café style atmosphere of Saint Louis Bread, known as Panera (Latin for "time for bread") outside the Saint Louis area, was proving to be successful. In 1996, comparable sales at Au Bon Pain locations declined 3% while same-store sales of the Panera unit were up 10%.[23]

Lacking the capital to overhaul the ambiance of the Au Bon Pain segment, the company decided to sell the unit. This allowed the company to strategically focus its time and resources on the more successful Panera chain. Unlike Au Bon Pain, Panera was not confined to a small urban niche and had greater growth potential. On May 16, 1999, Shaich sold the Au Bon Pain unit to investment firm Bruckman, Sherrill, and Co. for $73 million. At the time of the divestiture, the company changed its corporate name to Panera Bread Company. The sale left Panera Bread Company debt-free, and the cash allowed for the immediate expansion of its bakery-café stores.[24]

Throughout the 2000s, Panera grew through franchise agreements, acquisitions (including the purchase of Paradise Bakery & Café, Inc.), and new company-owned bakery-cafés. By 2009, Panera had become a national bakery-café concept with 1,380 company-owned and franchise-operated bakery-café locations in 40 states and in Ontario, Canada. Panera had grown from serving approximately 60 customers a day at its first bakery-café to serving nearly six million customers a week systemwide, becoming one of the largest food-service companies in the United States. The company believed its success was rooted in its ability to create long-term dining concept differentiation.[25] The company operated under the Panera®, Panera Bread®, Saint Louis Bread Co.®, Via Panera®, You Pick Two®, Mother Bread®, and Paradise Bakery & Café® design trademark names registered in the United States. Others were pending. Panera also had some of its marks registered in foreign countries.[26]

May 13, 2010, marked a significant change in the history of Panera Bread Company. After 28 years Ronald Shaich stepped down as CEO and Chairman effective immediately following the Annual Stockholders Meeting, and William Moreton, previously the Executive Vice President and co-Chief Operating Officer, assumed the role of CEO. Shaich planned to remain as the company's Executive Chairman. He announced that he expected to focus his time and energy within Panera on a range of strategic and innovation projects and mentoring the senior team. In typical Panera fashion, the transition had been planned for 1 1/2 years to ensure its success.

Concept and Strategy[27]

Concept

At the time when Panera was created, the fast-food industry was described as featuring low-grade burgers, greasy fries, and sugared colas. Shaich decided to create a casual but comfortable place where customers could eat fresh-baked artisan breads and fresh sandwiches, soups, and salads without worrying about whether it was nutritious.[28]

Panera's restaurant concept focused on the specialty bread/bakery-café category. Bread was Panera's platform and entry point to the Panera experience at its bakery-cafés. It was the symbol of Panera quality and a reminder of "Panera Warmth," the totality of the experience the customer received and could take home to share with friends and family. The company endeavored to offer a memorable experience with superior customer service. The company's associates were passionate about sharing their expertise and commitment with Panera customers. The company strove to achieve what Shaich termed "Concept Essence," Panera's blueprint for attracting targeted customers that the company believed differentiated it from competitors. Concept Essence included a focus on artisan bread, quality products, and a warm, friendly, and comfortable environment. It called for each of the company's bakery-cafés to be a place customers could trust to serve high-quality food. Panera's mission statement was "a loaf of Bread in every arm®."[29] Bread was Panera's passion, soul, expertise, and the platform that made all other of the company's food items special.

The company's bakery-cafés were principally located in suburban, strip mall, and regional mall locations and featured relaxing décor and free Internet access. Panera's bakery-cafés were designed to visually reinforce the distinctive difference between its bakery-cafés and those of its competititors.

Panera extended its strong values and concept of fresh food in an unpretentious, welcoming atmosphere to the nonprofit community. The company's bakery-cafés routinely donated bread and baked goods to community organizations in need. Panera's boldest step was the May 2010 opening of the Panera Cares bakery-café in Missouri, which had no set prices; instead, customers were asked to pay what they wanted.[30]

Panera's success in achieving its concept was often acknowledged through customer surveys and awards from the press. From Advertising Age[31] to Zagat,[32] Panera was touted as one of America's hottest brands and most popular chain. Customers rated Panera fifth overall in the restaurant industry in 2008 and highest among fast casual eateries in an annual customer satisfaction and quality survey conducted by Dandelman & Associates, a restaurant market research firm.[33] In 2009, Panera also was named number one on the "Healthiest for Eating on the Go" list by *Health* magazine for its variety of health menu options, whole grain breads, and half-sized items. Numerous other national and local awards had been received each year for the company's sandwiches, breads, lunches, soups, vegetarian offerings, cleanliness, Wi-Fi, community responsibility, best places to work, and kids' menu.[34] Panera's own consumer panel testing of 1,000 customers showed consistently high value perceptions of the company's products.[35]

Strategy

Panera operated in three business segments: company-owned bakery-café operations, franchise operations, and fresh dough operations. As of December 29, 2009, the company-owned bakery-café segment consisted of 585 bakery-cafes, all located in the United States, and the franchised operations segment consisted of 795 franchise-operated bakery-cafés, located throughout the United States and in Ontario, Canada. The company anticipated 80 to 90 systemwide bakery-cafés opening in 2010 with average weekly sales for company-owned new units of $36,000 to $38,000.[36] **Exhibit 1** shows the number and locations of all bakery-cafés in 2009. **Exhibit 2** shows the total number of systemwide bakery-cafés for the last five years. As of December 29, 2009, the company's fresh dough operations segment, which supplied fresh dough items daily to most company-owned and franchise-operated bakery-cafés, consisted of 23 fresh dough facilities. The locations and sizes of the fresh dough facilities can be found in **Exhibit 3**. Company-owned bakery-café operations accounted for 85.2% of revenues in 2009, up from 78% in 2005. Royalties and fees from franchise operations made up 5.8% of revenues in 2009, down from 8.5% in 2005, and fresh dough operations accounted for 9% of total revenues in 2009, down from 13.5% in 2005.[37]

EXHIBIT 1
Year-End 2009 Company-Owned and Franchise-Operated Bakery-Cafés: Panera Bread Co.

State	Company Bakery-Cafés	Franchise-Operated Bakery-Cafés	Total Bakery-Cafés
Alabama	14	—	14
Arizona	30	5	35
Arkansas	—	5	5
California	39	52	91
Colorado	—	35	35
Connecticut	11	10	21
Delaware	—	3	3
Florida	39	77	116
Georgia	14	18	32
Illinois	69	34	103
Indiana	32	6	38
Iowa	2	15	17
Kansas	—	18	18
Kentucky	15	2	17
Maine	—	4	4
Maryland	—	42	42
Massachusetts	8	36	44
Michigan	47	15	62
Minnesota	23	3	26
Missouri	45	21	66
Nebraska	11	2	13
Nevada	—	5	5
New Hampshire	—	9	9
New Jersey	—	48	48
New York	34	36	70
North Carolina	12	30	42
Ohio	9	89	98
Oklahoma	—	17	17
Oregon	5	4	9
Pennsylvania	23	46	69
Rhode Island	—	6	6
South Carolina	8	6	14
South Dakota	1	—	1
Tennessee	12	16	28
Texas	18	29	47
Utah	—	6	6
Virginia	53	10	63
Washington	11	1	12
West Virginia	—	7	7
Wisconsin	—	24	24
Canada	—	3	3
Totals	585	795	1,380

SOURCE: Panera Bread Company Inc., *2009 Form 10-K*, p. 16.

EXHIBIT 2 Company-Owned and Franchise-Operated Bakery-Cafés: Panera Bread Company

	For the Fiscal Year Ended				
	December 29, 2009	**December 30, 2008**	**December 25, 2007**	**December 26, 2006**	**December 27, 2005**
Number of Bakery-Cafés					
Company-owned					
Beginning of period	562	532	391	311	226
Bakery-cafés opened	30	35	89	70	66
Bakery-cafés closed	(7)	(5)	(5)	(3)	(2)
Bakery-cafés acquired from franchisees (1)	—	—	36	13	21
Bakery-cafés acquired (2)	—	—	22	—	—
Bakery-cafés sold to a franchisees (3)	—	—	(1)	—	—
End of period	585	562	532	391	311
Franchise-operated					
Beginning of period	763	698	636	566	515
Bakery-cafés opened	39	67	80	85	73
Bakery-cafés closed	(7)	(2)	(5)	(2)	(1)
Bakery-cafés sold to company (1)	—	—	(36)	(13)	(21)
Bakery-cafés acquired (2)	—	—	22	—	—
Bakery-cafés purchased from company (3)	—	—	1	—	—
End of period	795	763	698	636	566
Systemwide					
Beginning of period	1,325	1,230	1,027	877	741
Bakery-cafés opened	69	102	169	155	139
Bakery-cafés closed	(14)	(7)	(10)	(5)	(3)
Bakery-cafés acquired (2)	—	—	44	—	—
End of period	1,380	1,325	1,230	1,027	877

Notes:
(1) In June 2007, Panera acquired 32 bakery-cafés and the area development rights from franchisees in certain markets in Illinois and Minnesota. In February 2007, the company acquired four bakery-cafés, as well as two bakery-cafés still under construction, and the area development rights from a franchisee in certain markets in California.
In October 2006, Panera acquired 13 bakery-cafés (one of which was under construction) and the area development rights from a franchisee in certain markets in Iowa, Nebraska, and South Dakota. In September 2006, the company acquired one bakery-café in Pennsylvania from a franchisee. In November 2005, Panera acquired 23 bakery-cafés (two of which were under construction) and the area development rights from a franchisee in certain markets in Indiana.
(2) In February 2007, Panera acquired 51% of the outstanding capital stock of Paradise Bakery & Café Inc., which then owned and operated 22 bakery-cafés and franchised 22 bakery-cafés, principally in certain markets in Arizona and Colorado.
(3) In June 2007, Panera sold one bakery-café and die area development rights for certain markets in Southern California to a new area developer.

SOURCES: Panera Bread Company Inc., *2009 Form 10-K,* p. 25 and *2006 Form 10-K,* p. 20.

In addition to the dine-in and take-out business, the company offered Via Panera, a nationwide catering service that provided breakfast assortments, sandwiches, salads, or soups using the same high-quality ingredients offered in the company's bakery-cafés. Via Panera was supported by a national sales infrastructure. The company believed that Via Panera would be a key component of long-term growth.

EXHIBIT 3
Year-End 2009 Fresh Dough Facilities: Panera Bread Co.

Facility	Square Footage
Atlanta, GA	18,000
Beltsville, MD	26,800
Chicago, IL	30,900
Cincinnati, OH	22,300
Dallas, TX	12,900
Denver, CO	10,000
Detroit, MI	19,600
Fairfield, NJ	39,900
Franklin, MA (1)	40,300
Greensboro, NC	19,200
Kansas City, KS	17,000
Minneapolis, MN	10,300
Miramar, FL	15,100
Ontario, CA	27,800
Orlando, FL	16,500
Phoenix, AZ	9,100
Seattle, WA	16,600
St. Louis, MO	30,000
Stockton, CA	14,300
Warren, OH	16,300
Ontario, CAN (2)	300

Notes:
(1) Total square footage includes approximately 20,000 square feet utilized in tuna and cream cheese production.
(2) Company-owned limited production facility co-located with one of the franchised bakery-cafés in Ontario, Canada, to support the franchise-operated bakery-cafés located in this market.

SOURCE: Panera Bread Company Inc., *2009 Form 10-K,* p. 15.

The key initiatives of Panera's growth strategy focused on growing store profit, increasing transactions and gross profit per transaction, using its capital smartly, and putting in place drivers for concept differentiation and competitive advantage.[38] The company paid careful attention to the development of new markets and further penetration of existing markets by both company-owned and franchised bakery-cafés, including the selection of sites that would achieve targeted returns on invested capital.[39] Panera's strategy in 2009 was different from many of its competitors. When many restaurant companies were focused on surviving the economic meltdown by downsizing employees, discounting prices, and lowering quality, Panera chose to stay the course and continued to execute its long-term strategy of investing in the business to benefit the customer. The result, according to Shaich: "Panera zigged while others zagged."[40]

During the economic downturn, Panera stuck to a simple recipe: Get more cash out of each customer, rather than just more customers. While other recession-wracked restaurant chains discounted and offered meals for as little as $5 to attract customers, Panera bucked conventional industry wisdom by eschewing discounts and instead targeted customers who could afford to shell out an average of about $8.50 for lunch. While many of its competitors offered less expensive meals, Panera added a lobster sandwich for $16.99 at some of its locations. Panera was able to persuade customers to pay premiums because it had been improving the quality of its food.[41] "Most of the world seems to be focused on the Americans who are unemployed," said CEO Ronald Shaich. "We're focused on the 90 percent that are still employed."[42]

Panera's positive financial results contrasted with those of many other casual dining chains, which had posted negative same-store sales due partly to declining traffic and lower-priced

food. Some chains found that discounting not only hurt margins but also failed to lure as many customers as hoped. Shaich seemed to thrive on doing the opposite of his competition. During 2009, instead of slashing prices, he raised them twice, one on bagels and once on soup. "We're contrarians to the core," said Shaich. "We don't offer a lower-end strategy. In a world where everyone is cutting back, we want to give more not less."[43] "This is the time to increase the food experience," insisted Shaich, "that is, when consumers least expect it."[44]

Also crucial to Panera's success in 2009 was the company's approach to operations during the recession. Over the years, many restaurant companies told investors they were able to improve labor productivity while running negative comparable store sales. Panera believed that reducing labor in a restaurant taxed the customer by creating longer waits, slower service, and more frazzled team members. Panera took the approach of keeping labor consistent with sales and continuing to invest in its employees as a way to better serve its customers.[45]

The results for 2009 showed that Panera's strategy of zigging while others were zagging paid off. Panera met or exceeded its earnings targets in each quarter of 2009. Panera delivered 25% earnings per share (EPS) growth in 2009 on top of 24% EPS growth in 2008. Panera's stock price increased 115% from December 31, 2007, to March 30, 2010.

Panera's objectives for 2010 included a target of 17%–20% EPS growth through the execution of its key initiatives. To further build transactions, Panera planned to focus on differentiation through innovative salads utilizing new procedures to further improve quality. Panera also planned to test a new way to make paninis using newly designed grills. The company expected to roll out improved versions of several Panera classics while continuing to focus on improving operations, speed of service, and accuracy.[46]

In early 2010, to increase gross profit per transaction and further improve margins while still providing overall value to customers, Panera introduced an initiative called the Meal Upgrade Program. With this program, a customer who ordered an entrée and a beverage was offered the opportunity to purchase a baked good to complete their meal at a "special" price point. Panera intended to test other impulse add-on initiatives, bulk baked goods, and bread as a gift.[47]

"I worry about keeping the concept special," said Shaich. "Is it worth walking across the street to? It doesn't matter how cheap it is. If it isn't special, there's no reason the business needs to exist."[48]

The Fast Casual Segment

Panera's predecessor, Au Bon Pain, was a pioneer of the fast casual restaurant category. Dining trends caused fast casual to emerge as a legitimate trend in the restaurant industry as it bridged the gap between the burgers-and-fries fast-food industry and full service, sitdown, casual dining restaurants.

Technomic Information Services, a food-service industry consultant, coined the term to describe restaurants that offered the speed, efficiency, and inexpensiveness of fast food with the hospitality, quality, and ambiance of a full-service restaurant. Technomic defined a fast casual restaurant by whether or not the restaurant met the following four criteria: (1) The restaurant had to offer a limited service or self-service format. (2) The average check had to be between $6 and $9, whereas fast-food checks averaged less than $5. This pricing scheme placed fast casual between fast food and casual dining. (3) The food had to be made-to-order, as consumers perceived newly prepared, made-to-order foods as fresh. Fast casual menus usually also had more robust and complex flavor profiles than the standard fare at fast-food restaurants. (4) The décor had to be upscale or highly developed. Décor inspired a more enjoyable experience for the customer as the environment of fast casual restaurants was more akin to a neighborhood bistro or casual restaurant. The décor also created a generally higher perception of quality.[49]

The fast casual market was divided into three categories: bread-based chains, traditional chains, and ethnic chains. According to a Mintel 2008 report, bread-based chains, such as Panera, and ethnic chains, such as Chipotle Mexican Grill, had sales momentum and were predicted to grow at the expense of traditional chains such as Steak n Shake, Boston Market, Fuddruckers, and Fazoli's, which were weighted down by older concepts. The report also suggested that bread-based and ethnic chains had an edge with respect to consumer perceptions about food healthfulness.[50] Most fast casual brands did not compete in all dayparts (breakfast, lunch, dinner, late-night); rather, they focused on one or two. While almost all competitors in this segment had a presence at lunch, many grappled with the question of whether and how to participate in other dayparts.[51] In addition, unlike fast-food restaurants that constructed stand-alone stores, fast casual chains were typically located in strip malls, small town main streets, and pre-existing properties.

According to Technomic, by offering high-quality food with fast service, fast casual chains had experienced increased traffic in 2009 as diners "traded-down" from casual dining chains and "traded-up" from fast-food restaurants to lower priced but still higher-quality fresh food.[52] In other words, the desire to eat out did not diminish; only the destination changed. Sales in 2009 for the top 100 fast casual chains reached $17.5 billion, a 4.5% increase over 2008; and units grew by 4.3% to 14,777 locations,[53] compared to a 3.2% sales decline in the overall restaurant industry.[54] The growth in the fast casual segment was also due to the maturation of two large segments of the U.S. population; baby boomers and their children. Both age groups had little time for cooking and were tired of fast food.

Bakery-café/bagel remained the largest of the fast casual restaurant clusters and the largest menu category, generating $4.8 billion in U.S. sales in 2009 and jumping from 17% to 21% of the top 100 fast casual restaurants. In 2009, Mexican, with total sales of $3.8 billion, was the second largest fast casual cluster of restaurants.[55] Technomic's 2009 Top 100 Fast-Casual Restaurant Report noted that besides burgers (up 16.7%), the fastest growing menu categories reflected the growing interest of consumers in international flavors: Asian/noodle (up 6.4%) and Mexican (up 6.3%).[56]

According to Technomic, "Growth within the fast-casual segment reveals positive consumer preferences for the service format, concept, and menu positioning, and price points but competition is still fierce and dining-dollars are still minimal. Fast-casual operators will have to continue being creative with value-oriented menu offerings, uniqueness in terms of flavor, preparation and quality, and new ways to bolster the bottom line."[57] This is in agreement with a statement made by Panera's Chief Concept Officer, Scott Davis, "The key thing to remember about fast casual is this: customers don't know what it is. To them, 'fast casual' just means 'food.' That insight can go a long way toward helping you refocus your energy where it counts most. Food is what matters. It is the No. 1 way to differentiate your business from your competitors."[58]

Exhibit 4 provides a list of the 20 largest fast casual franchises in 2010. Even though Chipotle Mexican Grill was one of Panera's key competitors, it was not included on this list because it did not franchise. **Exhibit 5** lists the nine largest bread-based fast casual chains.

Competition

Panera experienced competition from numerous sources in its trade areas. The company's bakery-cafés competed with specialty food, casual dining and quick service cafés, bakeries, and restaurant retailers, including national, regional, and locally owned cafés, bakeries, and restaurants. The bakery-cafés competed in several segments of the restaurant business based on customers' needs for breakfast, AM "chill," lunch, PM "chill," dinner, and take-home through both on-premise sales and Via Panera catering. The competitive factors included location, environment, customer service, price, and quality of products. The company competed for leased space in desirable locations and also for hourly employees. Certain competitors or potential competitors had capital resources that exceeded those available to Panera.[59]

EXHIBIT 4
2010's Twenty Largest Fast Casual Franchises

	2009 United States Sales
1. Panera Bread	$2,796,500
2. Zaxby's	718,250
3. El Polio Loco	582,000
4. Boston Market	545,000
5. Jason's Deli	475,870
6. Five Guys Burgers and Fries	453,500
7. Qdoba Mexican Grill	436,500
8. Einstein Bros. Bagels	378,444
9. Moe's Southwestern Grill	358,000
10. McAlister's Deli	351,960
11. Fuddruckers	320,500
12. Wingstop	306,606
13. Baja Fresh Mexican Grill	300,000
14. Schlotzky's	248,000
15. Corner Bakery Café	235,029
16. Fazoli's	235,000
17. Noodles & Company	230,000
18. Bruegger's Bagel Bakery	196,000
19. Donatos Pizza	185,000
20. Cosi	168,500

Note:
(a) Not all key fast casual competitors are franchised restaurants.

SOURCE: *Technomic's 2010 Top 100 Fast-Casual Chain Restaurant Report, www.bluemaumau.cor/9057/2010's-top-twenty-largest-fastcausual-franchises.*

EXHIBIT 5
United States Systemwide Sales of Top Bread-Based Fast Casual Chains

	2005	2007
Panera Bread/Saint Louis Bread Co.	$1,508,000	$2,271,000
Jason's Deli	275,000	427,000
Einstein Bros. Bagels	358,000	416,000
McAlister's Deli	207,000	307,000
Au Bon Pain	271,000	265,000
Corner Bakery	173,000	230,000
Bruegger's	155,000	182,000
Cosi	136,000	174,000
Atlanta Bread	181,000	155,000

SOURCE: *Mintel Oxygen Report, August 2008.*

Panera's 2009 sales of nearly $2.8 billion ranked as the largest of the fast casual chains. The company saw an increase in sales of 7.1% and an increase in units of 4.3% to 1,380 stores over 2008. Chipotle Mexican Grill held on to the number two spot, growing U.S. sales 13.9% to $1.5 billion, and units by 14.2% to 955 locations in 2009.[60]

Panera and Chipotle Mexican Grill, which together made up more than 25% of the fast casual segment, posted double-digit percentage increases in first-quarter 2010 sales over the same period in 2009, driven by opening new outlets and robust increases in same-store sales. By contrast, United States revenues at McDonald's suffered in 2009, and for the first five

months of 2010, same-store sales were up 3% over the same period in 2009. Burger King struggled during the same period with revenues in the United States and Canada down 4% for the first three months of 2010.[61] Established restaurant chains were beginning to take notice of the opportunities in the fast casual segment and considering options. For example, Subway started testing an upscale design in the Washington, DC, market in 2008. New competitors, such as Otarian, were also entering the fast casual segment testing new concepts, many having a health and wellness or sustainability component to them.

Although Panera continued to learn from its competitors, none of its competitors had yet figured out the formula to Panera's success. While McDonald's had rival Burger King, and Applebee's had T.G.I. Friday's, there was no direct national competitor that replicated Panera's business model. Like Panera, Chipotle sold high-quality food made with fine ingredients—but it was Mexican. Cosi sold quality sandwiches and salads, but lacked pastries and gourmet coffees. Starbucks had fine coffee and pastries but not Panera's extensive food menu. According to Shaich, the reason is that "this is hard to do, . . . what seems simple can be tough. It is not so easy to knock us off."[62]

Corporate Governance

Panera was a Delaware corporation and its corporate headquarters were located in Saint Louis, Missouri.

Board of Directors

Panera's Board was divided into three classes of membership. The terms of service of the three classes of directors were staggered so that only one class expired at each annual meeting. At the time of the May 2010 annual meeting the Board consisted of six members. Class I consisted of Ronald M. Shaich and Fred K. Foulkes, with terms expiring in 2011; Class II consisted of Domenic Colasacco and Thomas E. Lynch, with terms expiring in 2012; and Class III consisted of Larry J. Franklin and Charles J. Chapmann III, with terms ending in 2010. Mr. Franklin and Mr. Chapman were both nominated for re-election with terms ending in 2013, if elected.[63]

The biographical sketches for the board members are shown below.[64]

Ronald M. Shaich: (age 56), was a Director since 1981, co-founder, Chairman of the Board since May 1999, Co-Chairman of the Board from January 1988 to May 1999, Chief Executive Officer since May 1994, and Co-Chief Executive Officer from January 1988 to May 1994. Shaich served as a Director of Lown Cardiovascular Research Foundation, as a trustee of the nonprofit Rashi School, as Chairman of the Board of Trustees of Clark University, and as Treasurer of the Massachusetts Democratic Party. He had a Bachelor of Arts degree from Clark University and an MBA from Harvard Business School. Immediately following the 2010 Annual Meeting, Mr. Shaich planned to resign as Chief Executive Officer and the Board intended to elect him as Executive Chairman of the Board.

Larry J. Franklin: (age 61), was a Director since June 2001. Franklin had been the President and Chief Executive Officer of Franklin Sports Inc., a leading branded sporting goods manufacturer and marketer, since 1986. Franklin joined Franklin Sports Inc. in 1970 and served as its Executive Vice President from 1981 to 1986. Franklin served on the Board of Directors of Bradford Soap International Inc. and the Sporting Goods Manufacturers Association (Chairman of the Board and member of the Executive Committee).

Fred K. Foulkes: (age 68), was a Director since June 2003. Dr. Foulkes had been a Professor of Organizational Behavior and had been the Director (and founder) of the Human Resources Policy Institute at Boston University School of Management since 1981. He had

taught courses in human resource management and strategic management at Boston University since 1980. From 1968 to 1980, Foulkes had been a member of the Harvard Business School faculty. Foulkes had written numerous books, articles, and case studies. He had served on the Board of Directors of Bright Horizons Family Solutions and the Society for Human Resource Management Foundation.

Domenic Colasacco: (age 61), was a Director since March 2000, and Lead Independent Director since 2008. Colasacco had been President and Chief Executive Officer of Boston Trust & Investment Management, a banking and trust company, since 1992. He also served as Chairman of its Board of Directors. He joined Boston Trust in 1974 after beginning his career in the research division of Merrill Lynch & Co. in New York City.

Charles J. Chapman III: (age 47), was a Director since 2008. Chapman had been the Chief Operating Officer and a Director of the American Dairy Queen Corporation since October 2005. From 2001 to October 2005, Chapman held a number of senior positions at American Dairy Queen. Prior to joining American Dairy Queen, Chapman served as Chief Operating Officer at Bruegger's Bagel's Inc. where he was also President and co-owner of a franchise. He also held marketing and operations positions with Darden Restaurants and served as a consultant with Bain & Company.

Thomas E. Lynch: (age 50), was a Director since March 2010 and previous Director from 2003–2006. Lynch served as Senior Managing Director of Mill Road Capital, a private equity firm, since 2005. From 2000 to 2004, Lynch served as Senior Managing Director of Mill Road Associates, a financial advisory firm that he founded in 2000. From 1997 through 2000, Lynch was the founder and Managing Director of Lazard Capital Partners From 1990 to 1997, Lynch was a Managing Director of the Blackstone Group, where he was a senior investment professional for Blackstone Capital Partners. Prior to Blackstone, Lynch was a senior consultant at the Monitor Company. He also had previously served on the Board of Directors of Galaxy Nutritional Foods Inc.

The Board had established three standing committees, each of which operated under a charter approved by the Board. The *Compensation and Management Development Committee* included Foulkes (Chair), Franklin, and Colasacco. The *Committee on Nominations and Corporate Governance* included Franklin (Chair), Chapman, and Foulkes. The *Audit Committee* included Colasacco (Chair), Foulkes, and Franklin.[65]

The compensation package of non-employee directors consisted of cash payments and stock and option awards. Total non-employee director compensation ranged from $29,724 to $124,851 in fiscal 2009 depending on services rendered.[66]

Top Management

The biographical sketches for some of the key executive officers follow.[67]

Ronald Shaich: (age 56) planned to resign as Chief Executive Officer immediately following the May 2010 Annual Meeting. The Board of Directors announced its intentions to elect him as Executive Chairman of the Board at that time. The Board intended to appoint William W. Moreton to succeed Mr. Shaich as Chief Executive Officer and President and to elect him to the Board of Directors.[68]

William M. Moreton: (age 50) re-joined Panera in November 2008 as Executive Vice President and Co-Chief Operating Officer. He previously served as Executive Vice President and Chief Financial Officer from 1998 to 2003. From 2005 to 2007, Moreton served as President and Chief Financial Officer of Potbelly Sandwich Works, and from 2004–2005 as Executive Vice President-Subsidiary Brands, and Chief Executive Officer of Baja Fresh, a subsidiary of Wendy's International Inc. Immediately following the conclusion

of the 2010 Annual Meeting, upon the resignation of Mr. Shaich, the Board planned for Mr. Moreton to succeed Mr. Shaich as Chief Executive Officer, and the Board intended to appoint him as President and elect him to the Board.

John M. Maguire: (age 44) had been Chief Operating Officer and subsequently Co-Chief Operating Officer since March 2008 and Executive Vice President since April 2006. He previously served as Senior Vice President, Chief Company, and Joint Venture Operations Officer from August 2001 to April 2006. From April 2000 to July 2001, Maguire served as Vice President, Bakery Operations and from November 1998 to March 2000, as Vice President, Commissary Operations. Maguire joined the company in April 1993; from 1993 to October 1998, he was a Manager and Director of Au Bon Pain/Panera Bread/ Saint. Louis Bread.

Cedric J. Vanzura: (age 46) had been Executive Vice President and Co-Chief Operating Officer since November 2008 and Executive Vice President and Chief Administrative Officer from March to November 2008. Prior to joining the company, Vanzura held a variety of roles at Borders International from 2003 to 2007.

Mark A. Borland: (age 57) had been Senior Vice President and Chief Supply Chain Officer since August 2002. Borland joined the company in 1986 and held management positions within Au Bon Pain and Panera Bread divisions until 2000, including Executive Vice President, Vice President of Retail Operations, Chief Operating Officer, and President of Manufacturing Services. From 2000 to 2001, Borland served as Senior Vice President of Operations at RetailDNA, and then rejoined Panera as a consultant in the summer of 2001.

Jeffrey W. Kip: (42) had been Senior Vice President and Chief Financial Officer since May 2006. He previously served as Vice President, Finance and Planning, and Vice President, Corporate Development, from 2003 to 2006. Prior to joining Panera, Mr. Kip was an Associate Director and then Director at UBS from 2002 to 2003 and an Associate at Goldman Sachs from 1999 to 2002.

Michael J. Nolan: (age 50) had been Senior Vice President and Chief Development Officer since he joined the company in August 2001. From December 1997 to March 2001, Nolan served as Executive Vice President and Director for John Harvard's Brew House, L.L.C., and Senior Vice President, Development, for American Hospitality Concepts Inc. From March 1996 to December 1997, Nolan was Vice President of Real Estate and Development for Apple South Incorporated, a chain restaurant operator, and from July 1989 to March 1996, Nolan was Vice President of Real Estate and Development for Morrison Restaurants Inc. Prior to 1989, Nolan served in various real estate and development capacities for Cardinal Industries Inc. and Nolan Development and Investment.

Other key Senior Vice Presidents included Scott Davis, Chief Concept Officer; Scott Blair, Chief Legal Officer; Rebecca Fine, Chief People Officer; Thomas Kish, Chief Information Officer; Michael Kupstas, Chief Franchise Officer; Michael Simon, Chief Marketing Officer; and William Simpson, Chief Company and Joint Venture Operations Officer. In 2009, the total compensation for the top five highest paid executive officers ranged from $939,919 to $3,354,708.[69]

At year-end 2009 there were two classes of stock: (1) Class A common stock with 30,491,278 shares outstanding and one vote per share, and (2) Class B common stock with 1,392,107 shares outstanding and three votes per share.[70] Class A common stock was traded on NASDAQ under the symbol PNRA. As of March 15, 2010, all directors, director nominees, and executive officers as a group (20 persons) held 1,994,642 shares or 6.22% of Class A common stock and 1,311,690 shares or 94.22% of Class B common stock with a combined voting percentage of 13.23%. Ronald Shaich owned 5.5% of Class A common stock and 94.22% of Class B common stock for a combined voting percentage of 12.42%.[71] In November 2009, Panera's Board of Directors approved a three-year share repurchase program of up to $600 million of Class A common stock.[72]

Menu[73]

Panera's value-oriented menu was designed to provide the company's target customers with affordably priced products built on the strength of the company's bakery expertise. "We hit a cord with people who understand and respond to food, but we also opened a door for people who are on the verge of that," said Scott Davis. "We run an idea through a Panera filter and give it a twist that takes a flavor profile closer to what you'd find in a bistro than a fast-food joint."[74] The Panera menu featured proprietary items prepared with high-quality fresh ingredients as well as unique recipes and toppings. The key menu groups were fresh-baked goods, including a variety of freshly baked bagels, breads, muffins, scones, rolls, and sweet goods; made-to-order sandwiches; hearty and unique soups; hand-tossed salads; and café beverages including custom-roasted coffees, hot or cold espresso, cappuccino drinks, and smoothies.

The company regularly reviewed and updated its menu offerings to satisfy changing customer preferences, to improve its products, and to maintain customer interest. To give its customers a reason to return, Panera had been rolling out new products with fresher ingredients such as antibiotic-free chicken (Panera is the nation's largest buyer[75]). The roots of most new Panera dishes could be traced to its R&D team's twice-yearly retreats to the Adirondacks, where staffers took turns trying to out-do each other in the kitchen. "We start with: What do we think tastes good," said Scott Davis. "We're food people, and if we're not working on something that gets us really excited, it's kind of not worth working on."[76] Panera did not have test kitchens and instead tested all new menu items directly in its cafés. According to Davis, "You can experiment all you want in the kitchen with a new product but you won't really see a measure of its potential until you see it in a store."[77]

Panera integrated new product rollouts into the company's periodic or seasonal menu rotations, referred to as "Celebrations." Examples of products introduced in fiscal 2009 included the Chopped Cobb Salad and Barbeque Chicken Chopped Salad, introduced during the 2009 summer salad celebration. Other menu changes in 2009 included a reformulated French baguette, a new line of smoothies, new coffee, a new Napa Almond Chicken Salad sandwich, a new Strawberry Granola Parfait, the Breakfast Power Sandwich, and a new line of brownies and blondies. Three new salmon options, five years in the making, were introduced in early 2010 along with a new Low-Fat Garden Vegetable Soup and a new Asiago Bagel Breakfast Sandwich. New chili offerings were in the planning stages. During this time Shaich had also been busy tweaking things he wanted Panera to do better, such as improving the freshness of Panera's lettuce by cutting the time from field to plate in half. He also improved the freshness of the company's breads by opting to bake all day long and not just in the early morning hours. Panera's changes and improvements were all designed to build competitive advantage by strengthening value. Value, according to the company, meant offering guests an even better "total experience."

In 2008, Panera introduced the antithesis to the microwaved, processed breakfast sandwich. "At Panera we believe customers deserve a breakfast that is made by bakers, not microwaves—so we have developed a hand-crafted, made to order grilled breakfast sandwich that literally breaks the mold," said Shaich. "Our survey shows that 82% of consumers would prefer freshly cooked eggs in their breakfast sandwiches and Panera is happy to oblige."[78] The new line of breakfast sandwiches were made fresh daily with quality ingredients—a combination of all-natural eggs, Vermont white cheddar cheese, Applewood-smoked bacon or all natural sausage, grilled between two slices of fresh baked ciabatta. Many of the company's competitors had also moved to more protein-based breakfast sandwich offerings because of the growth opportunities in this segment of the market. "To compete in this business, we believe we need to have offerings that are worth getting out of your car for,"[79] said Scott Davis.

Not all of Panera's menu innovations had been successful with customers or had added much to the bottom line. Panera redesigned its menu boards in 2009 to draw the customers' eyes toward meals with higher margins, like the soup and salad combo, rather than pricier

items, like a strawberry poppy-seed salad, that did not bring as much to the bottom line. The Crispani pizza was discontinued in 2008, after it failed to drive business during evening hours.

To improve margins, Panera was able to anticipate and react to changes in food and supply costs including, among other things, fuel, proteins, dairy, wheat, tuna, and cream cheese costs through increased menu prices and to use its strength at purchasing to limit cost inflation in efforts to drive gross profit per transaction.

"Panera's always been ahead of the curve in the transparency of their food,"[80] said Howard Gordon, a former Cheesecake Factory executive and now restaurant industry consultant. "Everyone said the antibiotic-free chicken was doomed to fail," said Shaich. "They said it was too expensive and too difficult for consumers to understand the value of paying more. Wrong."[81] Panera chose to be ahead of the curve again when it announced in early 2010 that it would post calorie information on all systemwide bakery-café menu boards by the end of 2010. Panera had for a number of years provided a nutritional calculator on its website so that customers were able to find nutritional information for individual products or build a meal according to their dietetic specifications. Recognizing the health risks associated with transfats, Panera had completely removed all transfat from its menu by 2006.[82] Panera also offered a wide range of organic food products including cookies, milk, and yogurt, which were incorporated into the company's childrens' menu, Panera Kids, in 2006. Because of its healthy choices, Panera was named "One of the 10 Best Fast-Casual Family Restaurants" by *Parents Magazine* in its July 2009 issue.[83]

Site Selection and Company-Owned Bakery-Cafés[84]

As of December 29, 2009, the company-owned bakery-café segment consisted of 585 company-owned bakery-cafés, all located in the United States. During 2009, Panera focused on using its cash to build new high ROI bakery-cafés and executed a disciplined development process that took advantage of the recession to drive down costs while selecting locations that delivered strong sales volume. In 2009, Panera believed the best use of its capital was to invest in its core business, either through the development of new bakery-cafés or through the acquisition of existing bakery-cafés from franchisees or other similar restaurant or bakery-café concepts, such as the acquisition of Paradise Bakery & Café Inc.

All company-owned bakery-cafés were in leased premises. Lease terms were typically 10 years with one, two, or three five-year renewal option periods thereafter. Leases typically had charges for a proportionate share of building and common area operating expenses and real estate taxes, and contingent percentage rent based on sales above a stipulated sales level. Because Panera was considered desirable as a tenant due to its profitable balance sheet and national reputation, the company enjoyed a favorable leasing environment in lease terms and the availability of desirable locations.

The average size of a company-owned bakery-café was approximately 4,600 square feet as of December 29, 2009. The average construction, equipment, furniture and fixtures, and signage costs for the 30 company-owned bakery-cafés opened in fiscal 2009 was approximately $750,000 per bakery-café after landlord allowances and excluding capitalized development overhead. The company expected that future bakery-cafés would require, on average, an investment per bakery-café of approximately $850,000.

In evaluating potential new locations for both company-owned and franchised bakery-cafés, Panera studied the surrounding trade area, demographic information within the most recent year, and publicly available information on competitors. Based on this analysis and utilizing predictive modeling techniques, Panera estimated projected sales and a targeted return on investment. Panera also employed a disciplined capital expenditure process focused on occupancy and development costs in relation to the market, designed to ensure the right-sized

bakery-café and costs in the right market. Panera's methods had proven successful in choosing a number of different types of locations, such as in-line or end-cap locations in strip or power centers, regional malls, drive-through, and freestanding units.

Franchises[85]

Franchising was a key component of Panera's growth strategy. Expansion through franchise partners enabled the company to grow more rapidly as the franchisees contributed the resources and capabilities necessary to implement the concepts and strategies developed by Panera.

The company began a broad-based franchising program in 1996, when the company actively began seeking to extend its franchise relationships. As of December 29, 2009, there were 795 franchise-operated bakery-cafés open throughout the United States and in Ontario, Canada, and commitments to open 240 additional franchise-operated bakery-cafés. At this time, 57.6% of the company's bakery-cafés were owned by franchises comprised of 48 franchise groups. The company was selective in granting franchises, and applicants had to meet specific criteria in order to gain consideration for a franchise. Generally, the franchisees had to be well capitalized to open bakery-cafés, with a minimum net worth of $7.5 million and meet liquidity requirements (liquid assets of $3 million),[86] have the infrastructure and resources to meet a negotiated development schedule, have a proven track record as multi-unit restaurant operators, and have a commitment to the development of the Panera brand. A number of markets were still available for franchise development.

Panera did not sell single-unit franchises. Instead, they chose to develop by selling market areas using Area Development Agreements, referred to as ADAs, which required the franchise developer to open a number of units, typically 15 bakery-cafés, in a period of four to six years. If franchisees failed to develop bakery-cafés on schedule or defaulted in complying with the company's operating or brand standards, the company had the right to terminate the ADA and to develop company-owned locations or develop locations through new area developers in that market.

The franchise agreement typically required the payment of an up-front franchise fee of $35,000 (broken down into $5,000 at the signing of the area development agreement and $30,000 at or before the bakery-café opens) and continued royalties of 4%–5% on sales from each bakery-café. The company's franchise-operated bakery-cafés followed the same protocol for in-store operating standards, product quality, menu, site selection, and bakery-café construction as did company-owned bakery-cafés. Generally, the franchisees were required to purchase all of their dough products from sources approved by the company.

The company did not generally finance franchise construction or area development agreement purchases. In addition, the company did not hold an equity interest in any of the franchise-operated bakery-cafés. However, in fiscal 2008, to facilitate expansion into Ontario, Canada, the company entered into a credit facility with the Canadian franchisee. By March 2010, Panera had repurchased the three franchises in Toronto in order to be more directly involved in the Canadian market. While the company thought the geographic market represented a good growth opportunity, Panera decided to study and learn from other U.S. firms that had expanded successfully in Canada.[87]

Bakery Supply Chain[88]

According to Ronald Shaich, "Panera has a commitment to doing the best bread in America."[89] Freshly baked bread made with fresh dough was integral to honoring this commitment. System-wide bakery-cafés used fresh dough for sourdough and artisan breads and bagels.

Panera believed its fresh dough facility system and supply chain function provided competitive advantage and helped to ensure consistent quality at its bakery-cafés. The company had a unique supply-chain operation in which dough was supplied daily from one of the company's regional fresh dough facilities to substantially all company-owned and franchise-operated bakery-cafés. Panera bakers then worked through the night shaping, scoring, and glazing the dough by hand to bring customers fresh-baked loaves every morning and throughout the day. In 2009, the company began baking loaves later in the morning to ensure freshness throughout the day and altered the fermentation cycle of its baguettes to make them sweeter.

As of December 29, 2009, Panera had 23 fresh dough facilities, 21 of which were company-owned, including a limited production facility that was co-located with one of the company's franchised bakery-cafés in Ontario, Canada, to support the franchise-operated bakery-cafés located in that market, and two of which were franchise operated. All fresh dough facilities were leased. In fiscal 2009, there was an average of 62.5 bakery-cafés per fresh dough facility compared to an average of 62.0 in fiscal 2008.[90]

Distribution of the fresh dough to bakery-cafés took place daily through a leased fleet of 184 temperature-controlled trucks driven by Panera employees. The optimal maximum distribution range for each truck was approximately 300 miles; however, when necessary, the distribution ranges might be up to 500 miles. An average distribution route delivered dough to seven bakery-cafés.

The company focused its expansion in areas served by the fresh dough facilities in order to continue to gain efficiencies through leveraging the fixed cost of its fresh dough facility structure. Panera expected to enter selectively new markets that required the construction of additional facilities until a sufficient number of bakery-cafés could be opened that permitted efficient distribution of the fresh dough.

In addition to its need for fresh dough, the company contracted externally for the manufacture of the remaining baked goods in the bakery-cafés, referred to as sweet goods. Sweet goods products were completed at each bakery-café by professionally trained bakers. Completion included finishing with fresh toppings and other ingredients and baking to established artisan standards utilizing unique recipes.

With the exception of products supplied directly by the fresh dough facilities, virtually all other food products and supplies for the bakery-cafés, including paper goods, coffee, and smallwares, were contracted externally by the company and delivered by vendors to an independent distributor for delivery to the bakery-cafés. In order to assure high-quality food and supplies from reliable sources, Panera and its franchisees were required to select from a list of approved suppliers and distributors. The company leveraged its size and scale to improve the quality of its ingredients, effect better purchasing efficiency, and negotiate purchase agreements with most approved suppliers to achieve cost reduction for both the company and its customers. One company delivered the majority of Panera's ingredients and other products to the bakery-cafés two or three times weekly. In addition, company-owned bakery-cafés and franchisees relied on a network of local and national suppliers for the delivery of fresh produce (three to six times per week).

Marketing[91]

Panera focused on customer research to plan its marketing and brand-building initiatives. According to Panera executives, "everything we do at Panera goes through the customer filter first."[92] Panera's target customers were between 25 and 50 years old, earned $40,000 to $100,000 a year, and were seeking fresh ingredients and high quality choices.[93] The company's customers spent an average of $8.50 per visit.[94]

Panera was committed to improving the customer experience in ways the company believed rare in the industry. The company leveraged its nationwide presence as part of a broader marketing strategy of building name recognition and awareness. As much as possible, the company used its store locations to market its brand image. When choosing a location to open a new store, Panera carefully selected the geographic area. Better locations needed less marketing, and the bakery-café concept relied on a substantial volume of repeat business.

In 2009, Panera executed a more aggressive marketing strategy than most of its competitors. While many competitors discounted to lure customers back through 2009, Panera focused on offering guests an even better "total experience." Improvements to the "total experience" included new coffee and breakfast items, new salads, new China, smoothies, and Mac and Cheese. The company focused on improving store profit by increasing transactions as well as increasing gross profit per transaction through the innovation and sales of higher gross profit items. Panera also had a successful initiative to drive add-on sales through the Meal Upgrade program.[95]

In 2010, Panera began modest increases in advertising and additional investments in its marketing infrastructure because the company recognized the importance of marketing as a driver of earnings and sales increases.[96] In spite of these increases, Panera remained very cautious about its marketing investments and focused on the appropriate mix for each market. Panera primarily used radio and billboard advertising, with some television, social networking, and in-store sampling days. Panera found that it benefited when other companies advertised products that Panera also carried, such as McDonald's early 2010 promotion of smoothies. Panera was testing additional television advertising in 20 markets but considered any significant growth in this medium to be a few years away.[97]

Panera's franchise agreements required franchisees to pay the company advertising fees based on a percentage of sales. In fiscal 2009, franchise-operated bakery-cafés contributed 0.7% of their sales to a company-run national advertising fund, paid a marketing administration fee of 0.4% of sales, and were required to spend 2.0% of their sales on advertising in their respective local markets. The company contributed the same sales percentages from company-owned bakery-cafés toward the national advertising fund and marketing administration fee. For fiscal 2010, the company increased the contribution rate to the national advertising fund to 1.1% of sales.[98]

Panera invested in cause-related marketing efforts and community activities through its Operation Dough-Nation program. These programs included sponsoring runs and walks, helping nonprofits raise funds, and the Day-End Dough-Nation program through which unsold bakery products were packaged at the end of each day and donated to local food banks and charities.[99]

Management Information Systems[100]

Each company-operated bakery-café had programmed point-of-sale registers to collect transaction data used to generate pertinent information, including transaction counts, product mix, and average check. All company-owned bakery-café product prices were programmed into the system from the company's corporate headquarters. The company allowed franchisees to have access to certain proprietary bakery-café systems and systems support. The fresh dough facilities had information systems that accepted electronic orders from the bakery-cafés and monitored delivery of the ordered product. The company also used proprietary online tools such as eLearning to provide online training for retail associates and online baking instructions for its bakers.

Panera's intranet site, The Harvest, allowed the company to monitor important analytics and provide support to its bakery-cafés. For example, Panera used a weather application on its

intranet that tied a bakery-café's historic local weather to the store's historic sales, allowing managers to forecast sales based on weather for any given day. "That helps in staffing and how you're going to allocate labor and what you need in terms of materials," said Greg Rhoades, Panera's senior manager in information services. He called The Harvest "our single source of information." Panera shared news with its employees about food safety and customer satisfaction websites and provided information on daily sales, hourly sales, staffing, product sales, labor costs, and ingredient costs.[101]

The company began offering Wi-Fi in its bakery-cafés in 2003. By 2010 most bakery-cafés provided customers free Internet access through a managed Wi-Fi network. As a result, Panera hosted one of the largest free public Wi-Fi networks in the country.[102]

In 2010, Panera began to pilot test a loyalty program, "My Panera," in 23 stores. Rather than just a food-discounting program, "My Panera" was intended to provide a deeper relationship with the customer by including participants in events such as the food tasting of new products. The company expected to complete the pilot by year-end 2010 and hoped to begin leveraging the data to better understand its high frequency customers and to "surprise and delight" them in a way that was tailored to the customers' buying habits.[103]

Human Resources[104]

From the beginning, Panera realized that the key ingredients to the successful development of the Panera brand ranged from the type of food it served to the kind of people behind the counters. The company placed a priority on staffing its bakery-cafés, fresh dough facilities, and support center operations with skilled associates and invested in training programs to ensure the quality of its operations. As of December 29, 2009, the company employed approximately 12,000 full-time associates (defined as associates who average 25 hours or more per week), of whom approximately 600 were employed in general or administrative functions, principally in the company's support centers; approximately 1,200 were employed in the company's fresh dough facility operations; and approximately 10,300 were employed in the company's bakery-café operations as bakers, managers, and associates. The company also had approximately 13,200 part-time hourly associates at the bakery-cafés. There were no collective bargaining agreements. The company considered its employee relations to be good.

Panera believed that providing bakery-café operators the opportunity to participate in the success of the bakery-cafés enabled the company to attract and retain experienced and highly motivated personnel, which resulted in a better customer experience. Through a Joint Venture Program, the company provided selected general managers and multi-unit managers with a multi-year bonus program based upon a percentage of the cash flows of the bakery-café they operated. The intent of the program's five-year period was to create team stability, generally resulting in a higher level of stability for that bakery-café and to lead to stronger associate engagement and customer loyalty. In December 2009, approximately 50% of company-owned bakery-café operators participated in the Joint Venture program.[105]

Finance

Panera reported a 48% increase in net income of $25,845 million, or $0.82 per diluted share, during the first quarter of 2010, compared to $17,432 million, or $0.57 per diluted share, during the first quarter of 2009. For this same period, Panera reported revenues of $364,210 million, a 14% gain, over revenues of $320,709 for the same period in 2009.[106]

Company-owned comparable bakery-café sales in the first quarter of fiscal 2010 increased 10.0%, due to transaction growth of 3.5% and average check growth of 6.5% over the comparable period in 2009. Franchise-operated comparable bakery-café sales increased 9.2% in the first quarter of 2010 compared to the same period in 2009. As a result, total comparable bakery-café sales increased 9.5% in the first quarter of fiscal 2010 compared to the comparable period in 2009.[107] In addition, average weekly sales (AWS) for newly opened company-owned bakery-cafés during the first quarter of 2010 were $56,111 compared to $41,922 in the first quarter of 2009. During the first quarter of 2010, Panera and its franchises opened eight new bakery-cafés systemwide. No bakery-cafés were closed during this period.[108]

Exhibits 6 to **8** provide Panera's consolidated statement of operations, common size income statements, and consolidated balance sheets, respectively, for the company for the fiscal years ended 2005 through 2009.

In fiscal 2009, during an uncertain economic environment, Panera bucked industry-wide trends and increased performance on the following key metrics: (1) systemwide comparable bakery-café sales growth of 0.5% (0.7% for company-owned bakery-cafés and 0.5% for franchise-operated bakery-cafés); (2) systemwide average weekly sales increased 1.8% to $39,926 ($39,050 for company-owned bakery-cafés and $40,566 for franchise-operated bakery-cafés); and (3) 69 new bakery-cafés opened systemwide (7 company-owned bakery-cafés and 39 franchise-operated bakery-cafés). In fiscal 2009, Panera earned $2.78 per diluted share.[109] In addition, average weekly sales (AWS) for newly opened company-owned bakery-cafés in 2009 reached a six-year high for new units.[110] **Exhibit 9** provides 2005–2009 selected financial information about Panera.

Total company revenue in fiscal 2009 increased 4.2% to $1,353.5 million from $1,298.9 million in fiscal 2008. This growth was primarily due to the opening of 69 new bakery-cafés systemwide in fiscal 2009 (and the closure of 14 bakery-cafés) and, to a lesser extent, the 0.5% increase in systemwide comparable bakery sales.

Company-owned bakery-café sales increased 4.2% in fiscal 2009 to $1,153.3 million compared to $1,106.3 million in fiscal 2008. This increase was due to the opening of 30 new company-owned bakery-cafés and to the 0.7% increase in comparable company-owned bakery-café sales in 2009. Company-owned bakery-café sales as a percentage of revenue remained consistent at 85.2% in both fiscal 2009 and fiscal 2008. In addition, the increase in average weekly sales for company-owned bakery-cafés in fiscal 2009 compared to the prior fiscal year was primarily due to the average check growth that resulted from the company's initiative to drive add-on sales. Franchise royalties and fees in fiscal 2009 were up 4.8% to $78.4 million, or 5.8% of total revenues, up from $74.8 million in 2008. Fresh dough sales to franchises increased 3.5% in fiscal 2009 to $121.9 million compared to $117.8 million in fiscal 2008.[111]

Panera believed that its primary capital resource was cash generated by operations. The company's principal requirements for cash have resulted from the company's capital expenditures for the development of new company-owned bakery-cafés; for maintaining or remodeling existing company-owned bakery-cafés; for purchasing existing franchise-operated bakery-cafés or ownership interests in other restaurant or bakery-café concepts; for developing, maintaining, or remodeling fresh dough facilities; and for other capital needs such as enhancements to information systems and infrastructure. The company had access to a $250 million credit facility which, as of December 29, 2009, had no borrowings outstanding. Panera believed its cash flow from operations and available borrowings under its existing credit facility to be sufficient to fund its capital requirements for the foreseeable future.[112]

According to Nicole Miller Regan, an analyst at Piper Jaffray, "the key to Panera's success during the recessionary period lies in what the company hasn't done. . . . It hasn't tried to change." [113] "For us, the recession has been the best of times," said CEO Shaich.[114]

EXHIBIT 6

Consolidated Statement of Operations: Panera Bread Company

	(Dollar amounts in thousands, except per share information) For the Fiscal Year Ended (1)				
	December 29, 2009	December 30, 2008	December 25, 2007	December 26, 2006	December 27, 2005
Revenues					
Bakery-café sales	$ 1,153,255	$ 1,106,295	$ 894,902	$ 666,141	$ 499,422
Franchise royalties and fees	78,367	74,800	67,188	61,531	54,309
Fresh dough sales to franchisee	121,872	117,758	104,601	101,299	86,544
Total revenue	1,353,494	1,298,853	1,066,691	828,971	640,275
Costs and Expenses					
Bakery-café expenses					
Cost of food and paper products	$ 337,599	$ 332,697	$271,442	$ 196,849	$ 143,057
Labor	370,595	352,462	286,238	204,956	151,524
Occupancy	95,996	90,390	70,398	48,602	35,558
Other operating expenses	155,396	147,033	121,325	92,176	70,003
Total bakery-café expenses	959,586	922,582	749,403	542,583	400,142
Fresh dough cost of sales to franchisees	100,229	108,573	92,852	85,951	74,654
Depreciation and amortization	67,162	67,225	57,903	44,166	33,011
General and administrative expenses	83,169	84,393	68,966	59,306	46,301
Pre-opening expenses	2,451	3,374	8,289	6,173	5,072
Total costs and expenses	1,212,597	1,186,147	977,413	738,179	559,180
Operating profit	140,897	112,706	89,278	90,792	81,095
Interest expense	700	1,606	483	92	50
Other (income) expense, net	273	883	333	(1,976)	(1,133)
Income before income taxes	139,924	110,217	88,462	92,676	82,178
Income taxes	53,073	41,272	31,434	33,827	29,995
Net income	86,851	68,945	57,028	58,849	52,183
Less: income (loss) attributable to noncontrolling interest	801	1,509	(428)		
Net income attributable to Panera Bread	$ 86,050	$ 67,436	$ 57,456	$ 58,849	$ 52,183
Per Share Data					
Earnings per common share attributable to Panera Bread Company					
Basic	$ 2.81	$ 2.24	$ 1.81	$ 1.88	$ 1.69
Diluted	$ 2.78	$ 2.22	$ 1.79	$ 1.84	$ 1.65
Weighted average shares of common and common equivalent shares outstanding					
Basic	30,667	30,059	31,708	31,313	30,871
Diluted	30,979	30,422	32,178	32,044	31,651

Notes:

(1) Fiscal 2008 was a 53-week year consisting of 371 days. All other fiscal years presented contained 52 weeks consisting of 364 days with the exception of fiscal 2005. In fiscal 2005, the company's fiscal week was changed to end on Tuesday rather than Saturday. As a result, the 2005 fiscal year ended on December 27, 2005, instead of December 31, 2005, and, therefore, consisted of 52 and a half weeks rather than the 53 week year that would have resulted without the calender change.

SOURCE: Panera Bread Company Inc., *2009 Form 10-K,* pp. 20–21.

EXHIBIT 7 Common Size Statement: Panera Bread Company

	(Percentages are in relation to total revenues except where otherwise indicated) For the Fiscal Year Ended				
	December 29, 2009	**December 30, 2008**	**December 25, 2007**	**December 26, 2006**	**December 27, 2005**
Revenues					
Bakery-café sales	85.2%	85.2%	83.9%	80.4%	78.0%
Franchise royalties and fees	5.8	5.8	6.3	7.4	8.5
Fresh dough sales to franchisee	9.0	9.1	9.8	12.2	13.5
Total revenue	100.0%	100.0%	100.0%	100.0%	100.0%
Costs and Expenses					
Bakery-café expense (l)					
Cost of food and paper products	29.3%	30.1%	30.3%	29.6%	28.6%
Labor	32.1	31.9	32.0	30.8	30.3
Occupancy	8.3	8.2	7.9	7.3	7.1
Other operating expenses	13.5	13.3	13.6	13.8	14.0
Total bakery-café expenses	83.2	83.4	83.7	81.5	80.0
Fresh dough cost of sales to franchisees (2)	82.2	92.2	88.8	84.5	86.7
Depreciation and amortization	5.0	5.2	5.4	5.3	5.2
General and administrative expenses	6.1	6.5	6.5	7.2	7.2
Pre-opening expenses	0.2	0.3	0.8	0.7	0.8
Total costs and expenses	**89.6**	**91.3**	**91.6**	**89.0**	**87.3**
Operating profit	10.4	8.7	8.4	11.0	12.7
Interest expense	0.1	0.1	0.1	—	—
Other (income) expense, net	—	0.1	—	-0.2	-0.2
Income before income taxes	10.3	8.5	8.3	11.2	12.8
Income taxes	3.9	3.2	2.9	4.1	4.7
Net income	**6.4**	**5.3**	**5.4**	**7.1**	**8.2**
Less: net income attributable to noncontrolling interest	0.1	0.1	—	—	—
Net income attributable to Panera Bread Company	**6.4%**	**5.2%**	**5.4%**	**7.1%**	**8.2%**

Notes:
(1) As a percentage of bakery-café sales.
(2) As a percentage of fresh dough facility sales to franchisees.

SOURCES: Panera Bread Company, Inc. 2009 *Form 10-K, p. 24 and 2006 Form 10-K,* p. 19.

EXHIBIT 8 Consolidated Balance Sheets: Panera Bread Company

	(Dollar amounts in thousands, except share and per share information) For the Fiscal Year Ended				
	December 29, 2009	**December 30, 2008**	**December 25, 2007**	**December 26, 2006**	**December 27, 2005**
Assets					
Current assets					
Cash and cash equivalents	$ 246,400	$ 74,710	$ 68,242	$ 52,097	$ 24,451
Short-term investments	—	2,400	23,198	20,025	36,200
Trade accounts receivable, net	17,317	15,198	25,122	19,041	18,229
Other accounts receivable	11,176	9,944	11,640	11,878	6,929
Inventories	12,295	11,959	11,394	8,714	7,358
Prepaid expenses	16,211	14,265	5,299	12,036	5,736
Deferred income taxes	18,685	9,937	7,199	3,827	3,871
Total current assets	322,084	138,413	152,124	127,618	102,774
Property and equipment, net	403,784	417,006	429,992	345,977	268,809
Other assets					
Goodwill	87,481	87,334	87,092	57,192	48,540
Other intangible assets, net	19,195	20,475	21,827	6,604	3,219
Long-term investments	—	1,726	—	—	10,108
Deposits and other	4,621	8,963	7,717	5,218	4,217
Total other assets	111,297	118,498	116,636	69,014	66,084
Total assets	$ 837,165	$ 673,917	$ 698.752	$ 542,609	$ 437,667
Liabilities and Stockholders' Equity					
Current liabilities					
Accounts payable	6,417	4,036	6,326	5,800	4,422
Accrued expenses	135,842	109,978	121,440	102,718	81,559
Deferred revenue	—	—	—	1,092	884
Total current liabilities	142,259	114,014	127,766	109,610	86,865
Long-term debt	—	—	75,000	—	—
Deferred rent	43,371	39,780	33,569	27,684	23,935
Deferred income taxes	28,813	—	—	—	5,022
Other long-term liabilities	25,686	21,437	14,238	7,649	4,867
Total liabilities	240,129	175,231	250,573	144,943	120,689
Stockholders' Equity					
Common stock, $.0001 par value: Class A, 75,000,000 shares authorized: 30,364,915 issued and 30,196,808 outstanding in 2009; 29,557,849 issued and 29,421,877 outstanding in 2008; 30,213,869 issued and 30,098,275 outstanding in 2007.	3	3	3	3	3
Class B, 10,000,000 shares authorized; 1,392,107 issued and outstanding in 2009; 1,398,242 in 2008; 1,398,588 in 2007; 1,400,031 in 2006 and 1,400,621 in 2005.	—	—	—	—	—

(*continued*)

EXHIBIT 8 Consolidated Balance Sheets: Panera Bread Company (*continued*)

Treasury stock, carried at cost;	(3,928)	(2,204)	(1,188)	(900)	(900)
Additional paid-in capital	168,288	151,358	168,386	176,241	154,402
Accumulated other comprehensive income (loss)	224	(394)	—	—	—
Retained earnings	432,449	346,399	278,963	222,322	163,473
Total stockholders' equity	597,036	495,162	446,164	397,666	316,978
Noncontrolling interest	—	3,524	2,015	—	—
Total equity	$ 597,036	$ 498,686	$ 446,164	$ 397,666	$ 316,978
Total equity and liabilities	$ 837,165	$ 673,917	$ 698,752	$ 542,609	$ 437,667

SOURCE: Panera Bread Company, Inc., 2009 Form 10-K, pp. 45; 2008 Form 10-K, p. 43; and 2006 Form 10-K, p.36.

EXHIBIT 9 Selected Financial Information: Panera Bread Company

(Dollar amounts in thousands)

A. Year to Year Comparable Sales Growth (not adjusted for differing number of weeks)

	For the Fiscal Year Ended				
	December 29, 2009 (52 weeks)	**December 30, 2008 (53 weeks)**	**December 25, 2007 (52 weeks)**	**December 26, 2006 (52 weeks)**	**December 27, 2005 (52-1/2 weeks)**
Company-owned	0.7%	5.8%	1.9%	3.9%	7.4%
Franchise-operated	0.5%	5.3%	1.5%	4.1%	8.0%
Systemwide	0.5%	5.5%	1.6%	4.1%	7.8%

B. System Wide Average Weekly Sales

	For the Fiscal Year Ended				
	December 29, 2009	**December 30, 2008**	**December 25, 2007**	**December 26, 2006**	**December 27, 2005**
Systemwide average weekly sales	$ 39,926	$ 39,239	$ 38,668	$ 39,150	$ 38,318

C. Company-owned Bakery-Café Average Weekly Sales

	For the Fiscal Year Ended				
	December 29, 2009	**December 30, 2008**	**December 25, 2007**	**December 26, 2006**	**December 27, 2005**
Company-owned average weekly sales	39,050	38,066	37,548	37,833	37,348
Company-owned number of operating weeks	29,533	29,062	23,834	176,077	13,280

D. Franchise-owned Bakery-Café Average Weekly Sales

	For the Fiscal Year Ended				
	December 29, 2009	**December 30, 2008**	**December 25, 2007**	**December 26, 2006**	**December 27, 2005**
Franchise average weekly sales	40,566	40,126	39,433	39,894	38,777
Franchise number of operating weeks	40,436	38,449	34,905	31,220	28,090

SOURCES: *Panera Bread Company, Inc., 2009 Form 10-K, p. 26–30 and 2008 Form 10-K, p. 25–27 and 2006 Form 10-K, p. 20–23.*

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CASE 33

Whole Foods Market 2010: How to Grow in an Increasingly Competitive Market? (Mini Case)

Patricia Harasta and Alan N. Hoffman

REFLECTING BACK OVER HIS THREE DECADES OF EXPERIENCE IN THE GROCERY BUSINESS, John Mackey smiled to himself over his previous successes. His entrepreneurial history began with a single store which he has now grown into the nation's leading natural food chain. Whole Foods is not just a food retailer but instead represents a healthy, socially responsible lifestyle that customers can identify with. The company has differentiated itself from competitors by focusing on quality as excellence and innovation that allows it to charge a premium price for premium products. While proud of the past, John had concerns about the future direction Whole Foods should head.

Company Background

Whole Foods carries both natural and organic food, offering customers a wide variety of products. "Natural" refers to food that is free of growth hormones or antibiotics, whereas "certificated organic" food conforms to the standards, as defined by the U.S. Department of Agriculture (USDA) in October 2002. Whole Foods Market® is the world's leading

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retailer of natural and organic foods, with 193 stores in 31 states, Canada, and the United Kingdom.

According to the company, Whole Foods Market is highly selective about what it sells, dedicated to stringent quality standards, and committed to sustainable agriculture. It believes in a virtuous circle entwining the food chain, human beings and Mother Earth: each is reliant upon the others through a beautiful and delicate symbiosis. The message of preservation and sustainability are followed while providing high-quality goods to customers and high profits to investors.

Whole Foods has grown over the years through mergers, acquisitions, and new store openings. The $565 million acquisition of its lead competitor, Wild Oats, in 2007 firmly set Whole Foods as the leader in the natural and organic food market and led to 70 new stores. The U.S. Federal Trade Commission (FTC) focused its attention on the merger on antitrust grounds. The dispute was settled in 2009, with Whole Foods closing 32 Wild Oats stores and agreeing to sell the Wild Oats Markets brand.

Although the majority of Whole Foods' locations are in the United States, European expansion provides enormous potential growth due to the large population and it holds a more sophisticated organic-foods market than the U.S. in terms of suppliers and acceptance by the public. Whole Foods targets its locations specifically by an area's demographics. The company targets locations where 40% or more of the residents have a college degree as they are more likely to be aware of nutritional issues.

Whole Foods Market's Philosophy

Whole Foods Market's corporate website defines the company philosophy as follows:

> *Whole Foods Market's vision of a sustainable future means our children and grandchildren will be living in a world that values human creativity, diversity, and individual choice. Businesses will harness human and material resources without devaluing the integrity of the individual or the planet's ecosystems. Companies, governments, and institutions will be held accountable for their actions.*

While Whole Foods recognizes it is only a supermarket, management is working toward fulfilling their vision within the context of the industry. In addition to leading by example, they strive to conduct business in a manner consistent with their mission and vision. By offering minimally processed, high-quality food, engaging in ethical business practices, and providing a motivational, respectful work environment, the company believes it is on the path to a sustainable future.

Whole Foods incorporates the best practices of each location back into the chain. This can be seen in the company's store product expansion from dry goods to perishable produce, including meats, fish, and prepared foods. The lessons learned at one location are absorbed by all, enabling the chain to maximize effectiveness and efficiency while offering a product line customers love. Whole Foods carries only natural and organic products. The best tasting and most nutritious food available is found in its purest state—unadulterated by artificial additives, sweeteners, colorings, and preservatives.

Employee and Customer Relations

Whole Foods encourages a team-based environment allowing each store to make independent decisions regarding its operations. Teams consist of up to 11 employees and a team leader. The team leaders typically head up one department or another. Each store employs anywhere from 72 to 391 team members. The manager is referred to as the "store team leader."

The "store team leader" is compensated by an Economic Value Added (EVA) bonus and is also eligible to receive stock options.

Whole Foods tries to instill a sense of purpose among its employees and has been named for 13 consecutive years as one of the "100 Best Companies to Work For" in America by *Fortune* magazine. In employee surveys, 90% of its team members stated that they always or frequently enjoy their job.

The company strives to take care of its customers, realizing they are the "lifeblood of our business," and the two are "interdependent on each other." Whole Foods' primary objective goes beyond 100% customer satisfaction with the goal to "delight" customers in every interaction.

Competitive Environment

At the time of Whole Foods' inception, there was almost no competition with less than six other natural food stores in the United States. Today, the organic foods industry is growing and Whole Foods finds itself competing hard to maintain its elite presence.

Whole Foods competes with all supermarkets. With more U.S. consumers focused on healthful eating, environmental sustainability, and the green movement, the demand for organic and natural foods has increased. More traditional supermarkets are now introducing "lifestyle" stores and departments to compete directly with Whole Foods. This can be seen in the Wild Harvest section of Shaw's, or the "Lifestyle" stores opened by conventional grocery chain Safeway.

Whole Foods' competitors now include big box and discount retailers who have made a foray into the grocery business. Currently, the United States' largest grocer is Wal-Mart. Not only does Wal-Mart compete in the standard supermarket industry, but it has even begun offering natural and organic products in its supercenter stores. Other discount retailers now competing in the supermarket industry include Target, Sam's Club, and Costco. All of these retailers offer grocery products, generally at a lower price than what one would find at Whole Foods.

Another of Whole Foods' key competitors is Los Angeles-based Trader Joe's, a premium natural and organic food market. By expanding its presence and product offerings while maintaining high quality at low prices, Trader Joe's has found its competitive niche. It has 215 stores, primarily on the west and east coasts of the United States, offering upscale grocery fare such as health foods, prepared meals, organic produce, and nutritional supplements. A low cost structure allows Trader Joe's to offer competitive prices while still maintaining its margins. Trader Joe's stores have no service department and average just 10,000 square feet in store size.

A Different Shopping Experience

The setup of the organic grocery store is a key component to Whole Foods' success. The store's setup and its products are carefully researched to ensure that they are meeting the demands of the local community. Locations are primarily in cities and are chosen for their large space and heavy foot traffic. According to Whole Foods' 10-K, "approximately 88% of our existing stores are located in the top 50 statistical metropolitan areas." The company uses a specific formula to choose store sites that is based upon several metrics, which include but are not limited to income levels, education, and population density.

Upon entering a Whole Foods supermarket, it becomes clear that the company attempts to sell the consumer on the entire experience. Team members (employees) are well trained and the stores themselves are immaculate. There are in-store chefs to help with recipes, wine tasting, and food sampling. There are "Take Action food centers" where customers can access

information on the issues that affect their food such as legislation and environmental factors. Some stores offer extra services such as home delivery, cooking classes, massages, and valet parking. Whole Foods goes out of its way to appeal to the above-average income earner.

Whole Foods uses price as a marketing tool in a few select areas, as demonstrated by the 365 Whole Foods brand name products priced less than similar organic products that are carried within the store. However, the company does not use price to differentiate itself from competitors. Rather, Whole Foods focuses on quality and service as a means of standing out from the competition.

Whole Foods spends much less than other supermarkets on advertising, approximately 0.4% of total sales in the fiscal year 2009. It relies heavily on word-of-mouth advertising from its customers to help market itself in the local community. The company advertises in several health conscious magazines, and each store budgets for in-store advertising each fiscal year.

Whole Foods also gains recognition via its charitable contributions and the awareness that they bring to the treatment of animals. The company donates 5% of its after-tax profits to not-for-profit charities. It is also very active in establishing systems to make sure that the animals used in their products are treated humanely.

The Green Movement

Whole Foods exists in a time where customers equate going green and being environmentally friendly with enthusiasm and respect. In recent years, people began to learn about food and the processes completed by many to produce it. Most of what they have discovered is disturbing. Whole Foods launched a nationwide effort to trigger awareness and action to remedy the problems facing the U.S. food system. It has decided to host 150 screenings of a 12 film series called "Let's Retake Our Plates," hoping to inspire change by encouraging and educating consumers to take charge of their food choices. Jumping on the bandwagon of the "go green" movement, Whole Foods is trying to show its customers that it is dedicated to not only all natural foods, but to a green world and healthy people. As more and more people become educated, the company hopes to capitalize on them as new customers.[1]

Beyond the green movement, Whole Foods has been able to tap into a demographic that appreciates the "trendy" theme of organic foods and all natural products. Since the store is associated with a type of affluence, many customers shop there to show they fit into this category of upscale, educated, new age people.

The Economic Recession of 2008

The uncertainty of today's market is a threat to Whole Foods. The expenditure income is low and "all natural foods" are automatically deemed as expensive. Because of people being laid off, having their salaries cut, or simply not being able to find a job, they now have to be more selective when purchasing things. While Whole Foods has been able to maintain profitability, it's questionable how long this will last if the recession continues or worsens. The reputation of organic products being costly may be enough to motivate people to not ever enter through the doors of Whole Foods. In California, the chain is frequently dubbed "Whole Paycheck."[2]

However, management understood that it must change a few things if the company was to survive the decrease in sales felt because customers were not willing to spend their money so easily. They have been working to correct this "pricey" image by expanding offerings of private-label products through their "365 Everyday Value" and "365 Organic" product lines. Private-label sales accounted for 11% of Whole Foods' total sales in 2009, up from 10% in 2008. They have also instituted a policy that their 365 product lines must match prices of similar products at Trader Joe's.[3]

Organic Foods as a Commodity

When Whole Foods first started in the natural foods industry in 1980 it was a relatively new concept. Over its first decade, Whole Foods enjoyed the benefits of offering a unique value proposition to consumers wanting to purchase high-quality natural foods from a trusted retailer. Over the last few years, however, the natural and organic foods industry has attracted the attention of general food retailers that have started to offer foods labeled as natural or organic at reasonable prices.

By 2007, the global demand for organic and natural foods far exceeded the supply. This is becoming a huge issue for Whole Foods, as more traditional supermarkets with higher purchasing power enter the premium natural and organic foods market. The supply of organic food has been significantly impacted by the entrance of Wal-Mart into the competitive arena. Due to the limited resources within the United States, Wal-Mart began importing natural and organic foods from China and Brazil, which led to it coming under scrutiny for passing off non-natural or organic products as the "real thing." Additionally, the quality of natural and organic foods throughout the entire market has been decreased due to constant pressure from Wal-Mart.

The distinction between what is truly organic and natural is difficult for the consumer to decipher as general supermarkets have taken to using terms such as "all natural," "free-range," and "hormone free," confusing customers. Truly organic food sold in the United States bears the "USDA Organic" label and needs to have at least 95% of the ingredients organic before it can get this distinction.[4]

In May 2003 Whole Foods became America's first Certified Organic grocer by a federally recognized independent third-party certification organization. In July 2009, California Certified Organic Growers (CCOF), one of the oldest and largest USDA-accredited third-party organic certifiers, individually certified each store in the United States, complying with stricter guidance on federal regulations. This voluntary certification tells customers that Whole Foods has gone the extra mile by not only following the USDA's Organic Rule, but opening its stores up to third-party inspectors and following a strict set of operating procedures designed to ensure that the products sold and labeled as organic are indeed organic—procedures that are not specifically required by the Organic Rule. This certification verifies the handling of organic goods according to stringent national guidelines, from receipt through repacking to final sale to customers. To receive certification, retailers must agree to adhere to a strict set of standards set forth by the USDA, submit documentation, and open their facilities to on-site inspections—all designed to assure customers that the chain of organic integrity is preserved.

Struggling to Grow in an Increasingly Competitive Market

Whole Foods has historically grown by opening new stores or acquiring stores in affluent neighborhoods targeting the wealthier and more educated consumers. This strategy has worked in the past; however, the continued focus on growth has been impacting existing store sales. Average weekly sales per store have decreased over the last number of years despite the fact that overall sales have been increasing. It is likely that this trend will continue unless Whole Foods starts to focus on growing sales within the stores it has and not just looking to increase overall sales by opening new stores. It is also increasingly difficult to find appropriate locations for new stores that are first and foremost in an area where there is limited competition and also to have the store in a location that is easily accessible by both consumers and the distribution network. Originally Whole Foods had forecast to open 29 new stores in 2010 but this has since been revised downward to 17.

Opening up new stores or the acquisition of existing stores is also costly. The average cost to open a new store ranges from $2 to $3 million, and it takes on average 8 to 12 months. A lot of this can be explained by the fact that Whole Foods custom builds the stores, which reduces the efficiencies that can be gained from the experience of having opened up many new stores previously. Opening new stores requires the company to adapt its distribution network, information management, supply, and inventory management, and adequately supply the new stores in a timely manner without impacting the supply to the existing stores. As the company expands, this task increases in complexity and magnitude.

The organic and natural foods industry overall has become a more concentrated market with few larger competitors having emerged from a more fragmented market composed of a large number of smaller companies. Future acquisitions will be more difficult for Whole Foods as the FTC will be monitoring the company closely to ensure that it does not violate any federal antitrust laws through the elimination of any substantial competition within this market.

Over the last number of years there has been an increasing demand by consumers for natural and organic foods. Sales of organic foods increased by 5.1% in 2009 despite the fact that U.S. food sales overall only grew by 1.6%.[5] This increase in demand and high margin availability on premium organic products led to an increasing number of competitors moving into the organic foods industry. Conventional grocery chains such as Safeway have remodeled stores at a rapid pace and have attempted to narrow the gap with premium grocers like Whole Foods in terms of shopping experience, product quality, and selection of takeout foods. This increase in competition can lead to the introduction of price wars where profits are eroded for both existing competitors and new entrants alike.

Unlike low-price leaders such as Wal-Mart, Whole Foods dominates because of its brand image, which is trickier to manage and less impervious to competitive threats. As competitors start to focus on emphasizing organic and natural foods within their own stores, the power of the Whole Foods brand will gradually decline over time as it becomes more difficult for consumers to differentiate Whole Foods' value proposition from that of its competitors.

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CASE 34

Burger King (Mini Case)

J. David Hunger

ORIGINALLY CALLED INSTA-BURGER KING, the company was founded in Florida in 1953 by Keith Kramer and Matthew Burns. Their Insta-Broiler oven was so successful at cooking hamburgers that they required all of their franchised restaurants to use the oven. After the chain ran into financial difficulties, it was purchased by its Miami-based franchisees, James McLamore and David Edgerton, in 1955. The new owners renamed the company Burger King. The restaurant chain introduced the first *Whopper* sandwich in 1957. Expanding to over 250 locations in the United States, the company was sold in 1967 to Pillsbury Corporation.

The company successfully differentiated itself from McDonald's, its primary rival, when it launched the *Have It Your Way* advertising campaign in 1974. Unlike McDonald's, which had made it difficult and time-consuming for customers to special-order standard items (such as a plain hamburger), Burger King restaurants allowed people to change the way a food item was prepared without a long wait.

Pillsbury (including Burger King) was purchased in 1989 by Grand Metropolitan, which in turn merged with Guinness to form Diageo, a British spirits company. Diageo's management neglected the Burger King business, leading to poor operating performance. Burger King was damaged to the point that major franchises went out of business and the total value of the

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firm declined. Diageo's management decided to divest the money-losing chain by selling it to a partnership private equity firm led by TPG Capital in 2002.

The investment group hired a new advertising agency to create (1) a series of new ad campaigns, (2) a changed menu to focus on male consumers, (3) a series of programs designed to revamp individual stores, and (4) a new concept called the BK Whopper Bar. These changes led to profitable quarters and re-energized the chain. In May 2006, the investment group took Burger King public by issuing an Initial Public Offering (IPO). The investment group continued to own 31% of the outstanding common stock.

Business Model

Burger King was the second largest fast-food hamburger restaurant chain in the world as measured by the total number of restaurants and systemwide sales. As of June 30, 2010, the company owned or franchised 12,174 restaurants in 76 countries and U.S. territories, of which 1,387 were company-owned and 10,787 were owned by franchisees. Of Burger King's restaurant total, 7,258 or 60% were located in the United States. The restaurants featured flame-broiled hamburgers, chicken and other specialty sandwiches, french fries, soft drinks, and other low-priced food items.

According to management, the company generated revenues from three sources: (1) retail sales at company-owned restaurants; (2) royalty payments on sales and franchise fees paid by franchisees; and (3) property income from restaurants leased to franchisees. Approximately 90% of Burger King restaurants were franchised, a higher percentage than other competitors in the fast-food hamburger category. Although such a high percentage of franchisees meant lower capital requirements compared to competitors, it also meant that management had limited control over franchisees. Franchisees in the United States and Canada paid an average of 3.9% of sales to the company in 2010. In addition, these franchisees contributed 4% of gross sales per month to the advertising fund. Franchisees were required to purchase food, packaging, and equipment from company-approved suppliers.

Restaurant Services Inc. (RSI) was a purchasing cooperative formed in 1992 to act as purchasing agent for the Burger King system in the United States. As of June 30, 2010, RSI was the distribution manager for 94% of the company's U.S. restaurants, with four distributors servicing approximately 85% of the U.S. system. Burger King had long-term exclusive contracts with Coca Cola and with Dr. Pepper/Seven-Up to purchase soft drinks for its restaurants.

Management touted its business strategy as growing the brand, running great restaurants, investing wisely, and focusing on its people. Specifically, management planned to accelerate growth between 2010 and 2015 so that international restaurants would comprise 50% of the total number. The focus in international expansion was to be in (1) countries with growth potential where Burger King was already established, such as Spain, Brazil, and Turkey; (2) countries with potential where the firm had a small presence, such as Argentina, Colombia, China, Japan, Indonesia, and Italy; and (3) attractive new markets in the Middle East, Eastern Europe, and Asia.

Management was also working to update the restaurants by implementing its new 20/20 design and complementary Whopper Bar design introduced in 2008. By 2010, more than 200 Burger King restaurants had adopted the new 20/20 design that evoked the industrial look of corrugated metal, brick, wood, and concrete. The new design was to be introduced in 95 company-owned restaurants during fiscal 2011.

Management was using a "barbell" menu strategy to introduce new products at both the premium and low-priced ends of the product continuum. As part of this strategy, the company introduced in 2010 the premium Steakhouse XT burger line and BK Fire-Grilled Ribs, the first

bone-in pork ribs sold at a national fast-food hamburger restaurant chain. At the other end of the menu, the company introduced in 2010 the ¼ pound Double Cheeseburger, the Buck Double, and the $1 BK Breakfast Muffin Sandwich.

Management continued to look for ways to reduce costs and boost efficiency. By June 30, 2010, point-of-sale cash register systems had been installed in all company-owned, and 57% of franchise-owned, restaurants. It had also installed a flexible batch broiler to maximize cooking flexibility and facilitate a broader menu selection while reducing energy costs. By June 30, 2010, the flexible broiler was in 89% of company-owned restaurants and 68% of franchise restaurants.

Industry

The fast-food hamburger category operated within the quick service restaurant (QSR) segment of the restaurant industry. QSR sales had grown at an annual rate of 3% over the past 10 years and were projected to continue increasing at 3% from 2010 to 2015. The fast-food hamburger restaurant (FFHR) category represented 27% of total QSR sales. FFHR sales were projected to grow 5% annually during this same time period. Burger King accounted for around 14% of total FFHR sales in the United States.

The company competed against market-leading McDonald's, Wendy's, and Hardee's restaurants in this category and against regional competitors, such as Carl's Jr., Jack in the Box, and Sonic. It also competed indirectly against a multitude of competitors in the QSR restaurant segment, including Taco Bell, Arby's, and KFC, among others. As the North American market became saturated, mergers occurred. For example, Taco Bell, KFC, and Pizza Hut were now part of Yum! Brands. Wendy's and Arby's merged in 2008. Although the restaurant industry as a whole had few barriers to entry, marketing and operating economies of scale made it difficult for a new entrant to challenge established U.S. chains in the FFHR category.

The quick service restaurant market segment appeared to be less vulnerable to a recession than other businesses. For example, during the quarter ended May 2010, both QSR and FFHR sales decreased 0.5%, compared to a 3% decline at both casual dining chains and family dining chains. The U.S. restaurant category as a whole declined 1% during the same time period.

America's increasing concern with health and fitness was putting pressure on restaurants to offer healthier menu items. Given its emphasis on fried food and saturated fat, the quick service restaurant market segment was an obvious target for likely legislation. For example, Burger King's recently introduced Pizza Burger was a 2,530-calorie item that included four hamburger patties, pepperoni, mozzarella, and Tuscan sauce on a sesame seed bun. Although the Pizza Burger may be the largest hamburger produced by a fast-food chain, the foot-long cheeseburgers of Hardee's and Carl's Jr. were similar entries. A health reform bill passed by the U.S. Congress in 2010 required restaurant chains with 20 or more outlets to list the calorie content of menu items. A study by the National Bureau of Economic Research found that a similar posting law in New York City caused the average calorie count per transaction to fall 6%, and revenue increased 3% at Starbucks stores where a Dunkin Donuts outlet was nearby. One county in California attempted to ban McDonald's from including toys in its high-calorie "Happy Meal" because legislators believed that toys attracted children to unhealthy food.

Issues

Even though Burger King was the second largest hamburger chain in the world, it lagged far behind McDonald's, which had a total of 32,466 restaurants worldwide. McDonald's averaged about twice the sales volume per U.S. restaurant and was more profitable than Burger King.

McDonald's was respected as a well-managed company. During fiscal year 2009 (ending December 31), McDonald's earned $4.6 billion on revenues of $22.7 billion. Although its total revenues had dropped from $23.5 billion in 2008, net income had actually increased from $4.3 billion in 2008. In contrast to most corporations, McDonald's common stock price had risen during the 2008–2010 recession, reaching an all-time high in August 2010.

In contrast, Burger King was perceived by industry analysts as having significant problems. As a result, Burger King's share price had fallen by half from 2008 to 2010. During fiscal year 2010 (ending June 30), Burger King earned $186.8 million on revenues of $2.50 billion. Although its total revenues had dropped only slightly from $2.54 billion in fiscal 2009 and increased from $2.45 billion in 2008, net income fell from $200.1 million in 2009 and $189.6 million in 2008. Even though same-store sales stayed positive for McDonald's during the recession, they dropped 2.3% for Burger King from fiscal 2009 to 2010. In addition, some analysts were concerned that expenses were high at Burger King's company-owned restaurants. Expenses as a percentage of total company-owned restaurant revenues were 87.8% in fiscal 2010 for Burger King compared to only 81.8% for McDonald's in fiscal 2009.

McDonald's had always emphasized marketing to families. The company significantly outperformed Burger King in both "warmth" and "competence" in consumers' minds. When McDonald's recently put more emphasis on women and older people by offering relatively healthy salads and upgraded its already good coffee, Burger King continued to market to young men by (according to one analyst) offering high-calorie burgers and ads featuring dancing chickens and a "creepy-looking" king. These young men were the very group who had been hit especially hard by the recession. According to Steve Lewis, who operated 36 Burger King franchises in the Philadelphia area, "overall menu development has been horrible. . . . We disregarded kids, we disregarded families, we disregarded moms." For example, sales of new, premium-priced menu items like the Steakhouse XT burger declined once they were no longer being advertised. One analyst stated that the company had "put a lot of energy into gimmicky advertising" at the expense of products and service. In addition, analysts commented that franchisees had also disregarded their aging restaurants.

Some analysts felt that Burger King may have cannibalized its existing sales by putting too much emphasis on value meals. For example, Burger King franchisees sued the company in 2009 over the firm's double-cheeseburger promotion, claiming that it was unfair for them to be required to sell these cheeseburgers for only $1 when they cost $1.10. Even though the price was subsequently raised to $1.29, the items on Burger King's "value menu" accounted for 20% of all sales in 2010, up from 12% in 2009.

New Owners: Time for a Strategic Change?

On September 2, 2010, 3G Capital, an investment group dominated by three Brazilian millionaires, offered $4 billion to purchase Burger King Holdings Inc. At $24 a share, the offer represented a 46% premium over Burger King's August 31 closing price. According to John Chidsey, Burger King's Charman and CEO, "It was a call out of the blue." Both the board of directors and the investment firms owning 31% of the shares supported acceptance of the offer. New ownership should bring a new board of directors and a change in top management. What should new management propose to ensure the survival and long-term success of Burger King?

CASE 35

Church & Dwight: Time to Rethink the Portfolio?

Roy A. Cook

"**A DECADE AGO, CHURCH & DWIGHT WAS A LARGELY HOUSEHOLD DOMESTIC PRODUCTS COMPANY** with one iconic brand, delivering less than $1 billion in annual sales. Today, the company has been transformed into a diversified packaged goods company with a well-balanced portfolio of leading household and personal care brands delivering over $2.5 in annual sales worldwide."[1] Now, after a decade of rapid growth fueled by a string of acquisitions, the top management team is faced with a new challenge. It must now rationalize the firm's expanded consumer products portfolio of 80 brands into the existing corporate structure while continuing to scout for new avenues of growth. This is no easy task as it competes for market share with such formidable consumer products powerhouses as Colgate-Palmolive, Clorox, and Procter & Gamble, commanding combined sales of over $100 billion. Future decisions will determine if the company can compete successfully with these other well-known giants in the consumer products arena or remain in their shadows.

Background

For over 160 years, Church & Dwight Co. Inc. has been working to build market share on a brand name that is rarely associated with the company. When consumers are asked, "Are you familiar with Church & Dwight products?" the answer is typically "No." Yet, Church &

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Dwight products can be found among a variety of consumer products in 95% of all U.S. households. As the world's largest producer and marketer of sodium bicarbonate-based products, Church & Dwight has achieved fairly consistent growth in both sales and earnings as new and expanded uses were found for its core sodium bicarbonate products. Although Church & Dwight may not be a household name, many of its core products bearing the ARM & HAMMER name are easily recognized.

Shortly after its introduction in 1878, ARM & HAMMER Baking Soda became a fundamental item on the pantry shelf as homemakers found many uses for it other than baking, such as cleaning and deodorizing. The ingredients that can be found in that ubiquitous yellow box of baking soda can also be used as a dentrifice, a chemical agent to absorb or neutralize odors and acidity, a kidney dialysis element, a blast media, an environmentally friendly cleaning agent, a swimming pool pH stabilizer, and a pollution-control agent.

Finding expanded uses for sodium bicarbonate and achieving orderly growth have been consistent targets for the company. Over the past 30 years, average company sales have increased 10%–15% annually. While top-line sales growth has historically been a focal point for the company, a shift may have occurred in management's thinking, as more emphasis seems to have been placed on bottom-line profitability growth. Since President and Chief Executive Officer James R. Cragie took over the helm of Church & Dwight from Robert A. Davies III in July of 2004, he has remained focused on "building a portfolio of strong brands with sustainable competitive advantages."[2] At that time, he proposed a strategy of reshaping the company through acquisitions and organic growth and he continues to state that "Our long-term objective is to maintain the company's track record of delivering outstanding TSR (Total Shareholder Return) relative to that of the S&P 500. Our long-term business model for delivering this sustained earnings growth is based on annual organic growth of 3–4%, gross margin expansion, tight management of overhead costs and operating margin improvement of 60–70 basis points resulting in sustained earnings growth of 10–12% excluding acquisitions."[3] In addition, Cragie noted that ". . . [W]e have added $1 billion in sales in the past five years, a 72% increase, while reducing our total headcount by 5%, resulting in higher revenue per employee than all of our major competitors."[4] The results of these efforts can be seen in the financial statements shown in **Exhibits 1**, **2**, and **3**.

Management

The historically slow but steady course Church & Dwight has traveled over the decades reflected stability in the chief executive office and a steady focus on long-term goals. The ability to remain focused may be attributable to the fact that about 25% of the outstanding shares of common stock were owned by descendants of the company's co-founders. Dwight C. Minton, a direct descendant of Austin Church, actively directed the company as CEO from 1969 through 1995 and remained on the board as Chairman Emeritus. He passed on the duties of CEO to the first non-family member in the company's history, Robert A. Davies III, in 1995 and leadership at the top has remained a stable hallmark of the company.

Many companies with strong brand names in the consumer products field have been susceptible to leveraged buy-outs and hostile takeovers. However, a series of calculated actions has spared Church & Dwight's board and management from having to make last-minute decisions to ward off unwelcome suitors. Besides maintaining majority control of the outstanding common stock, the board amended the company's charter, giving current shareholders four votes per share. However, they required future shareholders to buy and hold shares for four years before receiving the same privilege. The board of directors was also structured into three classes with four directors in each class serving staggered three-year terms. According to Minton, the objective of these moves was to "[give] the board control so as to provide the best results for shareholders."[5]

EXHIBIT 1
Consolidated Statements of Income: Church & Dwight Co. Inc. (Dollars in thousands, except per share data)

Year Ending December 31	2009	2008	2007
Net Sales	$ 2,520,922	$ 2,422,398	$ 2,220,940
Cost of sales	1,419,932	1,450,680	1,353,042
Gross Profit	1,100,990	971,718	867,898
Marketing expenses	353,588	294,130	256,743
Selling, general, and administrative expenses	354,510	337,256	306,121
Patent litigation settlement, net	(20,000)	—	—
Income from Operations	412,892	340,332	305,034
Equity in earnings of affiliates	12,050	11,334	8,236
Investment earnings	1,325	6,747	8,084
Other income (expense), net	1,537	(3,208)	2,469
Interest expense	(35,568)	(46,945)	(58,892)
Income before Income Taxes	392,236	308,260	264,931
Income taxes	148,715	113,078	95,900
Net income	243,521	195,182	169,031
Non-controlling interest	(12)	8	6
Net Income	$ 243,533	$ 195,174	$ 169,025
Weighted average shares outstanding—Basic	70,379	67,870	65,840
Weighted average shares outstanding—Diluted	71,477	71,116	70,312
Net income per share—Basic	$ 3.46	$ 2.88	$ 2.57
Net income per share—Diluted	$ 3.41	$ 2.78	$ 2.46
Cash dividends per share	$ 0.46	$ 0.34	$ 0.30

SOURCE: *Church & Dwight Co. Inc., 2009 Annual Report, p. 43.*

As a further deterrent to would-be suitors or unwelcome advances, the company entered into an employee severance agreement with key officials. This agreement provided severance pay of up to two times (three times for Mr. Cragie) the individual's highest annual salary and bonus plus benefits for two years (three years for Mr. Cragie) if the individual was terminated within one year after a change in control of the company. Change of control was defined as the acquisition by a person or group of 50% or more of company common stock; a change in the majority of the board of directors not approved by the pre-change board of directors; or the approval by the stockholders of the company of a merger, consolidation, liquidation, dissolution, or sale of all the assets of the company.[6]

As Church & Dwight pushed aggressively into consumer products outside of sodium bicarbonate-related products and into the international arena in the early 2000s, numerous changes were made in key personnel. These changes can be seen by reviewing **Exhibit 4** and noting the original date of hire for these key decision-makers. Many of the new members of the top management team brought extensive marketing and international experience from organizations such as Spalding Sports Worldwide, Johnson & Johnson, FMC, and Carter-Wallace.

In addition to the many changes that have taken place in key management positions, changes have also been made in the composition of the board of directors. Four members of the 10-member board have served for 10 years or more, whereas the other six members have served for five years or less. Two women serve on the board and ages of members range from 50 to 74, with six members being younger than 60. All but one of the newer additions to the board

EXHIBIT 2

Consolidated Balance Sheets: Church & Dwight Co. Inc. (Dollars in thousands, except share and per share data)

Year Ending December 31	2009	2008	2007
Assets			
Current assets			
Cash and cash equivalents	$ 447,143	$ 197,999	$ 249,809
Accounts receivable, less allowances of $5,782 and $5,427	222,158	211,194	247,898
Inventories	216,870	198,893	213,651
Deferred income taxes	20,432	15,107	13,508
Prepaid expenses	11,444	10,234	9,224
Other current assets	10,218	31,694	1,263
Total current assets	**928,265**	**665,121**	**735,353**
Property, plant, and equipment, net	455,636	384,519	350,853
Notes receivable	—	—	3,670
Equity investment in affiliates	12,815	10,061	10,324
Long-term supply contracts	—	—	2,519
Tradenames and other intangibles	794,891	810,173	665,168
Goodwill	838,078	845,230	688,842
Other assets	88,761	86,334	75,761
Total assets	**$ 3,118,446**	**$ 2,801,438**	**$ 2,532,490**
Liabilities and Stockholders' Equity			
Current liabilities			
Short-term borrowings	$ 34,895	$ 3,248	$ 115,000
Accounts payable and accrued expenses	332,450	310,622	303,071
Current portion of long-term debt	184,054	71,491	33,706
Income taxes payable	15,633	1,760	6,012
Total current liabilities	**567,032**	**387,121**	**457,789**
Long-term debt	597,347	781,402	707,311
Deferred income taxes	201,256	171,981	162,746
Deferred and other long-term liabilities	112,440	93,430	87,769
Pension, postretirement, and postemployment benefits	38,599	35,799	36, 416
Minority interest	—	—	194
Total liabilities	**1,516,674**	**1,469,733**	**1,452,225**
Commitments and contingencies stockholders' equity			
Preferred stock–$1.00 par value			
Authorized 2,500,000 shares, none issued	—	—	—
Common stock–$1.00 par value			
Authorized 300,000,000 shares, issued 73,213,775 shares	73,214	73,214	69,991
Additional paid-in capital	276,099	252,129	121,902
Retained earnings	1,275,117	1,063,928	891,868
Accumulated other comprehensive income (loss)	10,078	(20,454)	39,128
Common stock in treasury, at cost:			
2,664,312 shares in 2009 and 3,140,931 shares in 2008	(32,925)	(37,304)	(42,624)
Total Church & Dwight Co. Inc. stockholders' equity	**1,601,583**	**1,331,513**	**—**
Noncontrolling interest	189	192	—
Total stockholders' equity	**1,601,772**	**1,331,705**	**1,080,265**
Total Liabilities and Stockholders' Equity	**$ 3,118,446**	**$ 2,801,438**	**$ 2,532,490**

SOURCE: *Church & Dwight Co. Inc., 2009 Annual Report, p. 44.*

EXHIBIT 3
Business Segment Results: Church & Dwight Co. Inc.

	Consumer Domestic	Consumer International	Specialty Products	Corporate	Total
Net Sales					
2009	$1,881,748	$393,696	$245,478	$ —	$2,520,922
2008	1,716,801	420,192	285,405	—	2,422,398
2007	1,563,895	398,521	258,524	—	2,220,940
Income Before Income Taxes					
2009	$325,633	$38,562	$15,991	$12,050	$392,236
2008	236,956	34,635	25,335	11,334	308,260
2007	205,688	34,656	16,351	8,236	264,931

SOURCE: *Church & Dwight Co. Inc., 2009 Annual Report, p. 30.*

EXHIBIT 4
Key Officers: Management Positions and Tenure with Church & Dwight Co. Inc.

Name	Age	Position	Anniversary Date
James R. Cragie	56	President & Chief Executive Officer	2004
Jacquelin J. Brova	56	Executive Vice President, Human Resources	2002
Mark G. Conish	57	Executive Vice President, Global Operations	1975
Steven P. Cugine	47	Executive Vice President, Global New Products Innovation	1999
Matthew T. Farrell	53	Executive Vice President Finance and Chief Financial Officer	2006
Bruce F. Fleming	52	Executive Vice President and Chief Marketing Officer	2006
Susan E. Goldy	55	Executive Vice President, General Counsel and Secretary	2003
Adrian J. Huns	61	Executive Vice President, President International Consumer Products	2004
Joseph A. Sipia Jr.	61	Executive Vice President, President, and Chief Operating Officer, Specialty Products Division	2002
Paul A. Siracusa	53	Executive Vice President, Global Research and Development	2005
Louis H. Tursi	49	Executive Vice President, Domestic Consumer Sales	2004
Steven J. Katz	52	Vice President, Controller and Chief Accounting Officer	1986

SOURCE: *Notice of Annual Meeting of Stockholders and Proxy Statement, Church & Dwight Co. Inc., 2009, pages 11–12.*

brought significant consumer products and service industry insights from their ties with companies such as Revlon, ARAMARK, VF Corporation, Welch Foods, and H. J. Heinz. Although in a less active role as Chairman Emeritus, Dwight Church Minton, who became a board member in 1965, continued to provide leadership and a long legacy of "corporate memory."

Changing Directions

Entering the 21st century, ". . . [m]anagement recognized a major challenge to overcome . . . was the company's small size compared to its competitors in basic product lines of household and personal care. They also recognized the value of a major asset, the company's pristine balance sheet, and made the decision to grow."[7] According to Cragie, "Church & Dwight has

undergone a substantial transformation in the past decade largely as a result of three major acquisitions which doubled the size of the total company, created a well balanced portfolio of household and personal care businesses, and established a much larger international business."[8] The MENTADENT, PEPSODENT, AIM, and CLOSE-UP brands of toothpaste products were purchased from Unilever in October of 2003; the purchase of the remaining 50% of Armkel, the acquisition vehicle that had been used to purchase Carter-Wallace's consumer brands such as TROJAN, was completed in May of 2004; and SPINBRUSH was purchased from Procter & Gamble in October of 2005.

Five years later, another major acquisition was finalized when the stable of Orange Glow International products, including the well-known OXICLEAN brand, were added to the portfolio. The acquisitions didn't stop as Del Pharmaceutical's ORAGEL brands were added in 2008. What impact has this string of acquisitions made? The numbers speak for themselves as revenues have been pumped up from less than $500 million in 1995 to over $1 billion in 2001, then to $1.7 billion in 2005, and finally topping $2.5 billion in 2009.

Explosive growth through acquisitions transformed this once small company focused on a few consumer and specialty products into a much larger competitor, not only across a broader range of products, but also geographic territory. Consumer products now encompassed a broad array of personal care, deodorizing and cleaning, and laundry products while specialty products offerings were expanded to specialty chemicals, animal nutrition, and specialty cleaners. International consumer product sales, which were an insignificant portion of total revenue at the turn of the century, now accounted for 16% of sales. In the face of consumer products behemoths such as Clorox, Colgate-Palmolive, and Procter & Gamble, Church & Dwight had been able to carve out a respectable position with several leading brands. Regardless, the firm was not a major market force and needed to evaluate its portfolio of 80 different consumer brands.

Consumer Products

Prior to its acquisition spree, the company's growth strategy had been based on finding new uses for sodium bicarbonate. Using an overall family branding strategy to penetrate the consumer products market in the United States and Canada, Church & Dwight introduced additional products displaying the ARM & HAMMER logo. This logoed footprint remained significant as the ARM & HAMMER brand controlled a commanding 85% of the baking soda market. By capitalizing on its easily recognizable brand name, logo, and established marketing channels, Church & Dwight moved into such related products as laundry detergent, carpet cleaners and deodorizers, air deodorizers, toothpaste, and deodorant/antiperspirants. This strategy worked well, allowing the company to promote multiple products using only one brand name, but it limited growth opportunities ". . . in highly competitive consumer product markets, in which cost efficiency, new product offering and innovation are critical to success."[9]

From the company's founding until 1970, it produced and sold only two consumer products: ARM & HAMMER Baking Soda and a laundry product marketed under the name Super Washing Soda. In 1970, under Minton, Church & Dwight began testing the consumer products market by introducing a phosphate-free, powdered laundry detergent. Several other products, including a liquid laundry detergent, fabric softener sheets, an all-fabric bleach, tooth powder and toothpaste, baking soda chewing gum, deodorant/antiperspirants, deodorizers (carpet, room, and pet), and clumping cat litter have been added to the expanding list of ARM & HAMMER brands. However, simply relying on baking soda extensions and focusing on niche markets to avoid a head-on attack from competitors with more financial resources and marketing clout limited growth opportunities.

So, in the late 1990s, the company departed from its previous strategy of developing new product offerings in-house and bought several established consumer brands such as BRILLO,

PARSONS Ammonia, CAMEO Aluminum & Stainless Steel Cleaner, RAIN DROPS water softener, SNO BOWL toilet bowl cleaner, and TOSS 'N SOFT dryer sheets from one of its competitors, the Dial Corporation. An even broader consumer product assortment including TROJAN, NAIR, and FIRST RESPONSE was added to the company's mix of offerings with the acquisition of the consumer products business of Carter-Wallace in partnership with the private equity group, Armkel. The list of well-known brands was further enhanced with the acquisition of Crest's SPINBRUSH, Coty's line of ORAJEL products, and OXICLEAN, as well as other brands from Orange Glow International. In fact, acquisitions have been so important that seven of the company's eight brands are the result of these moves. The company has achieved significant success in the consumer products arena, as can be seen in **Exhibit 5**.

Church & Dwight faced the same dilemma as other competitors in mature domestic and international markets for consumer products. New consumer products had to muscle their way into markets by taking market share from larger competitors' current offerings. With the majority of company sales concentrated in the United States and Canada where sales were funneled through mass merchandisers, such as Wal-Mart (accounting for 22% of sales), supermarkets, wholesale clubs, and drugstores, it was well-equipped to gain market share with its low-cost strategy. In the international arena where growth was more product driven and less marketing sensitive, the company was less experienced. To compensate for this weakness, Church & Dwight relied on acquisitions and management changes to improve its international footprint and reach.

With its new stable of products and expanded laundry detergent offerings, Church & Dwight found itself competing head-on with both domestic and international consumer product giants such as Clorox, Colgate-Palmolive, Procter & Gamble, and Unilever. The breadth of its expanded consumer product offerings, composed of 60% premium and 40% value brand names, can be seen in **Exhibit 6**.

According to Minton, as the company grew, "We have made every effort to keep costs under control and manage frugally."[10] A good example of this approach to doing business can be seen in the Armkel partnership. "Armkel borrowed money on a non-recourse basis so a failure would have no impact on Church & Dwight, taking any risk away from shareholders."[11] As mentioned previously, the remaining interest in Armkel was purchased in 2005. This important move cleared the way to increase marketing efforts behind TROJAN, a brand which controlled 71% of the market.[12]

As more and more products were added to the consumer line-up, Church & Dwight brought many of its marketing tasks in-house as well as stepping out with groundbreaking and often controversial marketing campaigns. The first major in-house marketing project was in

EXHIBIT 5
Market Position of Key Church & Dwight Co. Inc. Brands

Brand Name	Market Position
ARM & HAMMER	In 9 out of 10 households in America
TROJAN	#1 condom brand
OXICLEAN	#1 laundry additive brand
SPINBRUSH	#1 battery-powered toothbrush brand
FIRST RESPONSE	#1 branded pregnancy kit
NAIR	#1 depilatory brand
ORAJEL	#1 oral care pain relief brand
XTRA	Leading deep value laundry detergent

SOURCE: *Church & Dwight Co. Inc., 2009 Annual Report, p. 1.*

EXHIBIT 6
Key Church & Dwight Co. Inc. Brand Names

Type of Product	Key Brand Names
Household	ARM & HAMMER Pure Baking Soda
	ARM & HAMMER Carpet & Room Deodorizers
	ARM & HAMMER Cat Litter Deodorizer
	ARM & HAMMER Clumping Cat Litters
	BRILLO Soap Pads
	SCRUB FREE Bathroom Cleaners
	CLEAN SHOWER Daily Shower Cleaner
	CAMEO Aluminum & Stainless Steel Cleaner
	SNO BOWL Toilet Bowl Cleaner
	ARM & HAMMER and XTRA Powder and Liquid Laundry Detergents
	XTRA and NICE 'N FLUFFY Fabric Softeners
	ARM & HAMMER FRESH 'N SOFT Fabric Softeners
	DELICARE Fine Fabric Wash
	ARM & HAMMER Super Washing Soda
	OXICLEAN Detergent and Cleaning Solution
	KABOOM Cleaning Products
	ORANGE GLO Cleaning Products
Personal Care	ARM & HAMMER Toothpastes
	SPINBRUSH Battery-operated Toothbrushes
	MENTADENT Toothpaste, Toothbrushes
	AIM Toothpaste
	PEPSODENT Toothpaste
	CLOSE-UP Toothpaste
	PEARL DROPS Toothpolish and Toothpaste
	RIGIDENT Denture Adhesive
	ARM & HAMMER Deodorants & Antiperspirants
	ARRID Antiperspirants
	LADY'S CHOICE Antiperspirants
	TROJAN Condoms
	NATURALAMB Condoms
	CLASS ACT Condoms
	FIRST RESPONSE Home Pregnancy and Ovulation Test Kits
	ANSWER Home Pregnancy and Ovulation Test Kits
	NAIR Depilatories, Lotions, Creams, and Waxes
	CARTERS LITTLE PILLS Laxative
	ORAJEL Oral Analgesics

SOURCE: *Form 10-K, 2009, pages 2–3.*

dental care. Although it entered a crowded field of specialty dental products, Church & Dwight rode the crest of increasing interest by both dentists and hygienists in baking soda for maintaining dental health—enabling it to sneak up on the industry giants. The company moved rapidly from the position of a niche player in the toothpaste market to that of a major competitor.

In a groundbreaking marketing campaign that some considered controversial, the company aired commercials for condoms on prime-time television. "Church & Dwight executives said their new campaign was designed to shake people up, particularly those who don't think they need to use condoms. Attempts were made to shock them out of complacency and grab

their attention."[13] Other campaigns, such as when the Trojan brand advertised its own stimulus package at the same time as the federal stimulus package was enacted, stated, "because we believe we should ride out these hard times together."[14] A Valentine's Day ad featuring condoms in place of candy in a heart-shaped box of chocolates continued to highlight the shock theme.[15]

The company's increasing marketing strength caught the attention of potential partners as is evidenced by its partnership with Quidel Corporation, a provider of point-of-care diagnostic tests, to meet women's health and wellness needs. "The partnership combined Church & Dwight's strength in the marketing, distribution and sales of consumer products with Quidel's strength in the development and manufacture of rapid diagnostic tests."[16] Other product tie-ins, especially with ARM & HAMMER Baking Soda, have been created with air filter, paint, and vacuum cleaner bag brands.

For the most part, Church & Dwight's acquired products and entries into the consumer products market have met with success. However, potential marketing problems may be looming on the horizon for its ARM & HAMMER line of consumer products. The company could be falling into the precarious line-extension snare. Placing a well-known brand name on a wide variety of products could cloud the brand's image, leading to consumer confusion and loss of marketing pull. In addition, competition in the company's core laundry detergent market continues to heat up as the market matures and sales fall with major retailers such as Wal-Mart and Target wringing price concessions from all producers.[17] Will the addition of such well-known brand names as ORAJEL, OXICLEAN, and SPINBRUSH continue the momentum gained from the XTRA, NAIR, TROJAN, and FIRST RESPONSE additions? Where would new avenues for consumer products' growth come from?

Specialty Products

In addition to a large and growing stable of consumer products, Church & Dwight also has a very solid core of specialty products. The Specialty Products Division basically consists of the manufacture and sale of sodium bicarbonate for three distinct market segments: specialty chemicals, animal nutrition products, and specialty cleaners. Manufacturers utilize sodium bicarbonate performance products as a leavening agent for commercial baked goods; an antacid in pharmaceuticals; a chemical in kidney dialysis; a carbon dioxide release agent in fire extinguishers; and an alkaline in swimming pool chemicals, detergents, and various textile and tanning applications. Animal feed producers use sodium bicarbonate nutritional products predominantly as a buffer, or antacid, for dairy cattle feeds and make a nutritional supplement that enhances milk production of dairy cattle. Sodium bicarbonate has also been used as an additive to poultry feeds to enhance feed efficiency.

"Church & Dwight has long maintained its leadership position in the industry through a strategy of sodium bicarbonate product differentiation, which hinges on the development of special grades for specific end users."[18] Management's apparent increased focus on consumer products has only recently impacted the significance of specialty products in the overall corporate mix of revenues, as is shown in **Exhibit 7**.

Church & Dwight was in an enviable position to profit from its dominant niche in the sodium bicarbonate products market since it controlled the primary raw material used in its production. The primary ingredient in sodium bicarbonate is produced from the mineral trona, which is extracted from the company's mines in southwestern Wyoming. The other ingredient, carbon dioxide, is a readily available chemical which can be obtained from a variety of sources. Production of the final product, sodium bicarbonate, for both consumer and specialty products is completed at one of the two company plants located in Green River, Wyoming, and Old Fort, Ohio.

The company maintained a dominant position in the production of the required raw materials for both its consumer and industrial products. It manufactures almost two-thirds

EXHIBIT 7
Revenues by Product Category as a Percent of Net Sales: Church & Dwight Co. Inc.

	2009	2008	2007	2006	2005	2004
Consumer domestic						
Household	47	45	45	43	41	47
Personal care	27	26	26	29	29	27
Consumer international	16	17	17	17	17	12
Specialty products	10	12	12	11	13	14
Total	100	100	100	100	100	100

SOURCE: *Company records.*

of the sodium bicarbonate sold in the United States and, until recently, was the only U.S. producer of ammonium bicarbonate and potassium carbonate. The company has the largest share (approximately 75%) of the sodium bicarbonate capacity in the United States and is the largest consumer of baking soda as it fills its own needs for company-produced consumer and industrial products.[19]

The Specialty Products Division focused on developing new uses for the company's core product, sodium bicarbonate. Additional opportunities continue to be explored for ARMEX Blast Media. This is a sodium bicarbonate-based product used as a paint-stripping compound. It gained widespread recognition when it was utilized successfully for the delicate task of stripping the accumulation of years of paint and tar from the interior of the Statue of Liberty without damaging the fragile copper skin. It is now being considered for other specialized applications in the transportation and electronics industries and in industrial cleaning because of its apparent environmental safety. ARMEX also has been introduced into international markets.

Specialty cleaning products are found in blasting (similar to sand blasting applications) as well as many emerging aqueous-based cleaning technologies such as automotive parts cleaning and circuit board cleaning. Safety-Kleen and Church & Dwight teamed up through a 50-50 joint venture, ARMAKLEEN, to meet the parts cleaning needs of automotive repair shops. Safety-Kleen's 2,800 strong sales and service team markets Church & Dwight's aqueous-based cleaners as an environmentally friendly alternative to traditional solvent-based cleaners.[20]

The company's ARMAKLEEN product is also used for cleaning printed circuit boards. This nonsolvent-based product may have an enormous potential market because it may be able to replace chlorofluorocarbon-based cleaning systems. Sodium bicarbonate also has been used to remove lead from drinking water and, when added to water supplies, coats the inside of pipes and prevents lead from leaching into the water. This market could grow in significance with additions to the Clean Water Bill. The search for new uses of sodium bicarbonate from pharmaceutical to environmental protection continues in both the consumer and industrial products divisions.

International Operations

Church & Dwight has traditionally enjoyed a great deal of success in North American markets and is attempting to gain footholds in international markets through acquisitions. The company's first major attempt to expand its presence in the international consumer products market was with the acquisition of DeWitt International Corporation, which manufactured and marketed personal care products including toothpaste. The DeWitt acquisition not only provided the company with increased international exposure but also with much-needed toothpaste production facilities and technology. However, until the 2001 acquisition of the Carter-Wallace line of products, only about 10% of sales were outside the United States.

EXHIBIT 8
International Markets for Church & Dwight Co. Inc. Products

Canada (36% of International Sales)	**France** (20% of International Sales)	**United Kingdom** (16% of International Sales)
Antiperspirants	Baby Care	Antiperspirants
Baking Soda	Depilatories	Baking Soda
Bathroom Cleaners	Diagnostics	Depilatories
Carpet & Room Deodorizer	Feminine Hygiene	Feminine Hygiene
Condoms	OTC Products	Pregnancy Kits
Depilatories	Skin Care	Skin Care
Gum	Toothpaste	Toothpaste
OTC Products		Toothpolish
Pregnancy Kits		
Toothpaste		
Mexico	**Middle East**	**Australia**
Baking Soda	Baking Soda	Baby Care
Brillo	Bathroom Cleaners	Depilatories
Condoms	Brillo	OTC Products
Depilatories	Carpet & Room Deodorizer	Pregnancy Kits
Gum	Fabric Softener	Toothpolish
OTC Products	Gum	
Pregnancy Kits	Toothpaste	
Toothpaste		
Toothpolish		
Korea	**Eastern Europe**	**Germany**
Baking Soda	Antiperspirant	Pregnancy Kits
Gum	Baking Soda	Toothpolish
Pet Care	Toothpaste	
Toothpaste		
Spain	**Japan**	
Depilatories	Baking Soda	
Skin Care		

SOURCE: *http://www.churchdwight.com/company/international.asp, retrieved 6/1/2010.*

By 2009, 19% of revenue was derived from sales outside the United States. Most of the growth in international markets was being fueled by consumer products, as shown in **Exhibit 8**.

As the company cautiously moved into the international arena of consumer products, it also continued to pursue expansion of its specialty products into international markets. Attempts to enter international markets have met with limited success, probably for two reasons: (1) lack of name recognition and (2) transportation costs. Although ARM & HAMMER was one of the most recognized brand names in the United States (in the top 10), it did not enjoy the same name recognition elsewhere. In addition, on an historic basis, international transportation costs were at least four times as much as domestic transportation costs. However, export opportunities continued to present themselves as 10% of all U.S. production of sodium bicarbonate was exported. While Church & Dwight dominated the United States sodium bicarbonate market, Solvay Chemicals was the largest producer in Europe and Ashi Glass was the largest producer in Asia. Although demand was particularly strong in Asia, ". . . little of the chemical produced in North America and Europe is exported to Asia because of prohibitive transportation costs."[21]

Streamlining

Two significant projects were completed in 2009. One was the completion and start-up of a major new manufacturing facility and the other was the disposition of some non-core assets.

With the completion of a 1.1 million square foot manufacturing plant for laundry detergent, the company consolidated into one facility the functions that had previously been completed in five separate facilities with room to grow. This move took place in an industry facing slowing growth. Global laundry detergent sales had grown by 8% between 2003 and 2008, but were only forecast to grow by 3% between 2008 and 2013.[22]

Although the company had made some minor asset sales in the past, the disposition in 2009 of five domestic and international consumer product brands acquired during the 2008 Del Laboratories transaction marked the first major jettisoning of non-core assets for the company. This was followed by the disposition of the Lambert Kay pet supplies line; then the BRILLO brand in March of 2010. These changes were just the beginning. To remain competitive in a volatile retail market with major competitors jockeying for shelf space and retailers seeking to rationalize their breadth of product offerings, more changes may be considered.

The core business and foundation on which the company was built remained the same after more than 160 years. However, as management looks to the future, can it successfully achieve a balancing act based on finding growth through expanded uses of sodium bicarbonate while assimilating a divergent group of consumer products into an expanding international footprint? Will the current portfolio of products continue to deliver the same results in the face of competitors who, unlike consumers, know the company and must react to its strategic and tactical moves?

NOTES

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GLOSSARY

10-K form An SEC form containing income statements, balance sheets, cash flow statements, and information not usually available in an annual report.

10-Q form An SEC form containing quarterly financial reports.

14-A form An SEC form containing proxy statements and information on a company's board of directors.

360-degree performance appraisal An evaluation technique in which input is gathered from multiple sources.

80/20 rule A rule of thumb stating that one should monitor those 20% of the factors that determine 80% of the results.

Absorptive capacity A firm's ability to value, assimilate, and utilize new external knowledge.

Acquisition The purchase of a company that is completely absorbed by the acquiring corporation.

Action plan A plan that states what actions are going to be taken, by whom, during what time frame, and with what expected results.

Activity ratios Financial ratios that indicate how well a corporation is managing its operations.

Activity-based costing (ABC) An accounting method for allocating indirect and fixed costs to individual products or product lines based on the value-added activities going into that product.

Adaptive mode A decision-making mode characterized by reactive solutions to existing problems, rather than a proactive search for new opportunities.

Advisory board A group of external business people who voluntarily meet periodically with the owners/managers of the firm to discuss strategic and other issues.

Affiliated directors Directors who, though not really employed by the corporation, handle the legal or insurance work for the company or are important suppliers.

Agency theory A theory stating that problems arise in corporations because the agents (top management) are not willing to bear responsibility for their decisions unless they own a substantial amount of stock in the corporation.

Altman's Bankruptcy Formula A formula used to estimate how close a company is to declaring bankruptcy.

Analytical portfolio manager A type of general manager needed to execute a diversification strategy.

Andean Community A South American free-trade alliance composed of Columbia, Ecuador, Peru, Bolivia, and Chili.

Annual report A document published each year by a company to show its financial condition and products.

Assessment center An approach to evaluating the suitability of a person for a position by simulating key parts of the job.

Assimilation A strategy that involves the domination of one corporate culture over another.

Association of South East Asian Nations (ASEAN) A regional trade association composed of Asian countries of Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. ASEA+3 includes China, Japan, and South Korea.

Autonomous (self-managing) work teams A group of people who work together without a supervisor to plan, coordinate, and evaluate their own work.

Backward integration Assuming a function previously provided by a supplier.

Balanced scorecard Combines financial measures with operational measures on customer satisfaction, internal processes, and the corporation's innovation and improvement activities.

Bankruptcy A retrenchment strategy that forfeits management of the firm to the courts in return for some settlement of the corporation's obligations.

Basic R&D Research and development that is conducted by scientists in well-equipped laboratories where the focus is on theoretical problem areas.

BCG (Boston Consulting Group) Growth-Share Matrix A simple way to portray a corporation's portfolio of products or divisions in terms of growth and cash flow.

Behavior control A control that specifies how something is to be done through policies, rules, standard operating procedures, and orders from a superior.

Behavior substitution A phenomenon that occurs when people substitute activities that do not lead to goal accomplishment for activities that do lead to goal accomplishment because the wrong activities are being rewarded.

Benchmarking The process of measuring products, services, and practices against those of competitors or companies recognized as industry leaders.

Best practice A procedure that is followed by successful companies.

Blind spot analysis An approach to analyzing a competitor by identifying its perceptual biases.

Board of director responsibilities Commonly agreed obligations of directors, which include: setting corporate strategy, overall direction, mission or vision; hiring and firing the CEO and top management; controlling, monitoring, or supervising top management; reviewing and approving the use of resources; and caring for shareholder interest.

Board of directors' continuum A range of the possible degree of involvement by the board of directors (from low to high) in the strategic management process.

BOT (build-operate-transfer) concept A type of international entry option for a company. After building a facility, the company operates the facility for a fixed period of time during which it earns back its investment, plus a profit.

Brainstorming The process of proposing ideas in a group without first mentally screening them.

Brand A name that identifies a particular company's product in the mind of the consumer.

Budget A statement of a corporation's programs in terms of money required.

Business model The mix of activities a company performs to earn a profit.

Business plan A written strategic plan for a new entrepreneurial venture.

Business policy A previous name for strategic management. It has a general management orientation and tends to look inward with primary concern for integrating the corporation's many functional activities.

Business strategy Competitive and cooperative strategies that emphasize improvement of the competitive position of a corporation's products or services in a specific industry or market segment.

Cannibalize To replace popular products before they reach the end of their life cycle.

Cap-and-trade A government-imposed ceiling (cap) on the amount of allowed greenhouse gas emissions combined with a system allowing a firm to sell (trade) its emission reductions to another firm whose emissions exceed the allowed cap.

Capability A corporation's ability to exploit its resources.

Capital budgeting The process of analyzing and ranking possible investments in terms of the additional outlays and additional receipts that will result from each investment.

Captive company strategy Dedicating a firm's productive capacity as primary supplier to another company in exchange for a long-term contract.

Carbon footprint The amount of greenhouse gases being created by an entity and released into the air.

Cash cow A product that brings in far more money than is needed to maintain its market share.

Categorical imperatives Kant's two principles to guide actions: A person's action is ethical only if that person is willing for that same action to be taken by everyone who is in a similar situation, and a person should never treat another human being simply as a means but always as an end.

Cautious profit planner The type of leader needed for a corporation choosing to follow a stability strategy.

Cellular/modular organization structure A structure composed of cells (self-managing teams, autonomous business units, etc.) that can operate alone but can interact with other cells to produce a more potent and competent business mechanism.

Center of excellence A designated area in which a company has a core or distinctive competence.

Center of gravity The part of the industry value chain that is most important to the company and the point where the company's greatest expertise and capabilities lay.

Central American Free Trade Agreement (CAFTA) A regional trade association composed of El Salvador, Guatemala, Nicaragua, Honduras, Costa Rica, the United States, and the Dominican Republic.

Clusters Geographic concentrations of interconnected companies and industries.

Code of ethics A code that specifies how an organization expects its employees to behave while on the job.

Codetermination The inclusion of a corporation's workers on its board of directors.

Collusion The active cooperation of firms within an industry to reduce output and raise prices in order to get around the normal economic law of supply and demand. This practice is usually illegal.

Commodity A product whose characteristics are the same regardless of who sells it.

Common-size statements Income statements and balance sheets in which the dollar figures have been converted into percentages.

Competency A cross-functional integration and coordination of capabilities.

Competitive intelligence A formal program of gathering information about a company's competitors.

Competitive scope The breadth of a company's or a business unit's target market.

Competitive strategy A strategy that states how a company or a business unit will compete in an industry.

Competitors The companies that offer the same products or services as the subject company.

Complementor A company or an industry whose product(s) works well with another industry's or firm's product and without which that product would lose much of its value.

Concentration A corporate growth strategy that concentrates a corporation's resources on competing in one industry.

Concentric diversification A diversification growth strategy in which a firm uses its current strengths to diversify into related products in another industry.

Concurrent engineering A process in which specialists from various functional areas work side by side rather than sequentially in an effort to design new products.

Conglomerate diversification A diversification growth strategy that involves a move into another industry to provide products unrelated to its current products.

Conglomerate structure An assemblage of legally independent firms (subsidiaries) operating under one corporate umbrella but controlled through the subsidiaries' boards of directors.

Connected line batch flow A part of a corporation's manufacturing strategy in which components are standardized and each machine functions like a job shop but is positioned in the same order as the parts are processed.

Consensus A situation in which all parties agree to one alternative.

Consolidated industry An industry in which a few large companies dominate.

Consolidation The second phase of a turnaround strategy that implements a program to stabilize the corporation.

Constant dollars Dollars adjusted for inflation.

Continuous improvement A system developed by Japanese firms in which teams strive constantly to improve manufacturing processes.

Continuous systems Production organized in lines on which products can be continuously assembled or processed.

Continuum of sustainability A representation that indicates how durable and imitable an organization's resources and capabilities are.

Contraction The first phase of a turnaround strategy that includes a general across-the-board cutback in size and costs.

Cooperative strategies Strategies that involve working with other firms to gain competitive advantage within an industry.

Co-opetition A term used to describe simultaneous competition and cooperation among firms.

Core competency A collection of corporate capabilities that cross divisional borders and are widespread within a corporation, and is something that a corporation can do exceedingly well.

Core rigidity/deficiency A core competency of a firm that over time matures and becomes a weakness.

Corporate brand A type of brand in which the company's name serves as the brand name.

Corporate capabilities See capability.

Corporate culture A collection of beliefs, expectations, and values learned and shared by a corporation's members and transmitted from one generation of employees to another.

Corporate culture pressure A force from existing corporate culture against the implementation of a new strategy.

Corporate entrepreneurship Also called intrapreneurship, the creation of a new business within an existing organization.

Corporate governance The relationship among the board of directors, top management, and shareholders in determining the direction and performance of a corporation.

Corporate parenting A corporate strategy that evaluates the corporation's business units in terms of resources and capabilities that can be used to build business unit value as well as generate synergies across business units.

Corporate reputation A widely held perception of a company by the general public.

Corporate scenario Pro forma balance sheets and income statements that forecast the effect that each alternative strategy will likely have on return on investment.

Corporate stakeholders Groups that affect or are affected by the achievement of a firm's objectives.

Corporate strategy A strategy that states a company's overall direction in terms of its general attitude toward growth and the management of its various business and product lines.

Corporation A mechanism legally established to allow different parties to contribute capital, expertise, and labor for their mutual benefit.

Cost focus A low-cost competitive strategy that concentrates on a particular buyer group or geographic market and attempts to serve only that niche.

Cost leadership A low-cost competitive strategy that aims at the broad mass market.

Cost proximity A process that involves keeping the higher price a company charges for higher quality close enough to that of the competition so that customers will see the extra quality as being worth the extra cost.

Crisis of autonomy A time when people managing diversified product lines need more decision-making freedom than top management is willing to delegate to them.

Crisis of control A time when business units act to optimize their own sales and profits without regard to the overall corporation. See also *suboptimization*.

Crisis of leadership A time when an entrepreneur is personally unable to manage a growing company.

Cross-functional work teams A work team composed of people from multiple functions.

Cultural integration The extent to which units throughout an organization share a common culture.

Cultural intensity The degree to which members of an organizational unit accept the norms, values, or other culture content associated with the unit.

Deculturation The disintegration of one company's culture resulting from unwanted and extreme pressure from another to impose its culture and practices.

Dedicated transfer line A highly automated assembly line making one mass-produced product using little human labor.

Defensive centralization A process in which top management of a not-for-profit retains all decision-making authority so that lower-level managers cannot take any actions to which the sponsors may object.

Defensive tactic A tactic in which a company defends its current market.

Delphi technique A forecasting technique in which experts independently assess the probabilities of specified events. These assessments are combined and sent back to each expert for fine-tuning until agreement is reached.

Devil's advocate An individual or a group assigned to identify the potential pitfalls and problems of a proposal.

Dialectical inquiry A decision-making technique that requires that two proposals using different assumptions be generated for consideration.

Differentiation A competitive strategy that is aimed at the broad mass market and that involves the creation of a product or service that is perceived throughout its industry as unique.

Differentiation focus A differentiation competitive strategy that concentrates on a particular buyer group, product line segment, or geographic market.

Differentiation strategy See differentiation.

Dimensions of national culture A set of five dimensions by which each nation's unique culture can be identified.

Directional strategy A plan that is composed of three general orientations: growth, stability, and retrenchment.

Distinctive competencies A firm's competencies that are superior to those of competitors.

Diversification A corporate growth strategy that expands product lines by moving into another industry.

Divestment A retrenchment strategy in which a division of a corporation with low growth potential is sold.

Divisional structure An organizational structure in which employees tend to be functional specialists organized according to product/market distinctions.

Downsizing Planned elimination of positions or jobs.

Due care The obligation of board members to closely monitor and evaluate top management.

Durability The rate at which a firm's underlying resources and capabilities depreciate or become obsolete.

Dynamic industry expert A leader with a great deal of experience in a particular industry appropriate for executing a concentration strategy.

Dynamic capabilities Capabilities that are continually being changed and reconfigured to make them more adaptive to an uncertain environment.

Dynamic pricing A marketing practice in which different customers pay different prices for the same product or service.

Earnings per share (EPS) A calculation that is determined by dividing net earnings by the number of shares of common stock issued.

Economic value added (EVA) A shareholder value method of measuring corporate and divisional performance. Measures after-tax operating income minus the total annual cost of capital.

Economies of scale A process in which unit costs are reduced by making large numbers of the same product.

Economies of scope A process in which unit costs are reduced when the value chains of two separate products or services share activities, such as the same marketing channels or manufacturing facilities.

EFAS (External Factor Analysis Summary) table A table that organizes external factors into opportunities and threats and how well management is responding to these specific factors.

Electronic commerce The use of the Internet to conduct business transactions.

Engineering (or process) R&D R&D concentrating on quality control and the development of design specifications and improved production equipment.

Enterprise resource planning (ERP) software Software that unites all of a company's major business activities, from order processing to production, within a single family of software modules.

Enterprise risk management (ERM) A corporatewide, integrated process to manage the uncertainties that could negatively or positively influence the achievement of the corporation's objectives.

Enterprise strategy A strategy that explicitly articulates a firm's ethical relationship with its stakeholders.

Entrepreneur A person who initiates and manages a business undertaking and who assumes risk for the sake of a profit.

Entrepreneurial characteristics Traits of an entrepreneur that lead to a new venture's success.

Entrepreneurial mode A strategy made by one powerful individual in which the focus is on opportunities, and problems are secondary.

Entrepreneurial venture Any new business whose primary goals are profitability and growth and that can be characterized by innovative strategic practices.

Entry barrier An obstruction that makes it difficult for a company to enter an industry.

Environmental scanning The monitoring, evaluation, and dissemination of information from the external and internal environments to key people within the corporation.

Environmental sustainability The use of business practices to reduce a company's impact upon the natural, physical environment.

Environmental uncertainty The degree of complexity plus the degree of change existing in an organization's external environment.

Ethics The consensually accepted standards of behavior for an occupation, trade, or profession.

European Union (EU) A regional trade association composed of 27 European countries.

Evaluation and control A process in which corporate activities and performance results are monitored so that actual performance can be compared with desired performance.

Executive leadership The directing of activities toward the accomplishment of corporate objectives.

Executive succession The process of grooming and replacing a key top manager.

Executive type An individual with a particular mix of skills and experiences.

Exit barrier An obstruction that keeps a company from leaving an industry.

Expense center A business unit that uses money but contributes to revenues only indirectly.

Experience curve A conceptual framework that states that unit production costs decline by some fixed percentage each time the total accumulated volume of production in units doubles.

Expert opinion A nonquantitative forecasting technique in which authorities in a particular area attempt to forecast likely developments.

Explicit knowledge Knowledge that can be easily articulated and communicated.

Exporting Shipping goods produced in a company's home country to other countries for marketing.

External environment Forces outside an organization that are not typically within the short-run control of top management.

External strategic factor Environmental trend with both high probability of occurrence and high probability of impact on the corporation.

Externality Costs of doing business that are not included in a firm's accounting system, but felt by others.

Extranet An information network within an organization that is available to key suppliers and customers.

Extrapolation A form of forecasting that extends present trends into the future.

Family business A company that is either owned or dominated by relatives.

Family directors Board members who are descendants of the founder and own significant blocks of stock.

Financial leverage The ratio of total debt to total assets.

Financial strategy A functional strategy to make the best use of corporate monetary assets.

First mover The first company to manufacture and sell a new product or service.

Flexible manufacturing A type of manufacturing that permits the low-volume output of custom-tailored products at relatively low unit costs through economies of scope.

Follow-the-sun-management A management technique in which modern communication enables project team members living in one country to pass their work to team members in another time zone so that the project is continually being advanced.

Forward integration Assuming a function previously provided by a distributor.

Four-corner exercise An approach to analyzing a competitor in terms of its future goals, current strategy, assumptions, and capabilities, in order to develop a competitor's response profile.

Fragmented industry An industry in which no firm has large market share and each firm serves only a small piece of the total market.

Franchising An international entry strategy in which a firm grants rights to another company/individual to open a retail store using the franchiser's name and operating system.

Free cash flow The amount of money a new owner can take out of a firm without harming the business.

Full vertical integration A growth strategy under which a firm makes 100% of its key supplies internally and completely controls its distributors.

Functional strategy An approach taken by a functional area to achieve corporate and business unit objectives and strategies by maximizing resource productivity.

Functional structure An organizational structure in which employees tend to be specialists in the business functions important to that industry, such as manufacturing, sales, or finance.

GE Business Screen A portfolio analysis matrix developed by General Electric, with the assistance of the McKinsey & Company consulting firm.

Geographic-area structure A structure that allows a multinational corporation to tailor products to regional differences and to achieve regional coordination.

Global industry An industry in which a company manufactures and sells the same products, with only minor adjustments for individual countries around the world.

Globalization The internationalization of markets and corporations.

Global warming A gradual increase in the Earth's temperature leading to changes in the planet's climate.

Goal displacement Confusion of means with ends, which occurs when activities originally intended to help managers attain corporate objectives become ends in themselves or are adapted to meet ends other than those for which they were intended.

Goal An open-ended statement of what one wants to accomplish, with no quantification of what is to be achieved and no time criteria for completion.

Good will An accounting term describing the premium paid by one company in its purchase of another company that is listed on the acquiring company's balance sheet.

Grand strategy Another name for directional strategy.

Green-field development An international entry option to build a company's manufacturing plant and distribution system in another country.

Greenwash A derogatory term referring to a company's promoting its environmental sustainability efforts with very little action toward improving its measurable environmental performance.

Gross domestic product (GDP) A measure of the total output of goods and services within a country's borders.

Growth strategies A directional strategy that expands a company's current activities.

Hierarchy of strategy A nesting of strategies by level from corporate to business to functional, so that they complement and support one another.

Horizontal growth A corporate growth concentration strategy that involves expanding the firm's products into other geographic locations and/or increasing the range of products and services offered to current markets.

Horizontal integration The degree to which a firm operates in multiple geographic locations at the same point in an industry's value chain.

Horizontal strategy A corporate parenting strategy that cuts across business unit boundaries to build synergy across business units and to improve the competitive position of one or more business units.

House of quality A method of managing new product development to help project teams make important design decisions by getting them to think about what users want and how to get it to them most effectively.

Human resource management (HRM) strategy A functional strategy that makes the best use of corporate human assets.

Human diversity A mix of people from different races, cultures, and backgrounds in the workplace.

Hypercompetition An industry situation in which the frequency, boldness, and aggressiveness of dynamic movement by the players accelerates to create a condition of constant disequilibrium and change.

Idea A concept that could be the foundation of an entrepreneurial venture if the concept is feasible.

IFAS (Internal Factor Analysis Summary) table A table that organizes internal factors into strengths and weaknesses and how well management is responding to these specific factors.

Imitability The rate at which a firm's underlying resources and capabilities can be duplicated by others.

Index of R&D effectiveness An index that is calculated by dividing the percentage of total revenue spent on research and development into new product profitability.

Index of sustainable growth A calculation that shows how much of the growth rate of sales can be sustained by internally generated funds.

Individual rights approach An ethics behavior guideline that proposes that human beings have certain fundamental rights that should be respected in all decisions.

Individualism-collectivism (IC) The extent to which a society values individual freedom and independence of action compared with a tight social framework and loyalty to the group.

Industry A group of firms producing a similar product or service.

Industry analysis An in-depth examination of key factors within a corporation's task environment.

Industry matrix A chart that summarizes the key success factors within a particular industry.

Industry scenario A forecasted description of an industry's likely future.

Information technology strategy A functional strategy that uses information systems technology to provide competitive advantage.

Input control A control that specifies resources, such as knowledge, skills, abilities, values, and motives of employees.

Inside director An officer or executive employed by a corporation who serves on that company's board of directors; also called management director.

Institution theory A concept of organizational adaptation that proposes that organizations can and do adapt to changing conditions by imitating other successful organizations.

Institutional advantage A competitive benefit for a not-for-profit organization when it performs its tasks more effectively than other comparable organizations.

Integration A process that involves a relatively balanced give-and-take of cultural and managerial practices between merger partners, with no strong imposition of cultural change on either company.

Integration manager A person in charge of taking an acquired company through the process of integrating its people and processes with those of the acquiring company.

Intellectual property Special knowledge used in a new product or process developed by a company for its own use and is usually protected by a patent, copyright, trademark, or trade secret.

Interlocking directorate A condition that occurs when two firms share a director or when an executive of one firm sits on the board of a second firm.

Intermittent system A method of manufacturing in which an item is normally processed sequentially, but the work and the sequence of the processes vary.

Internal environment Variables within the organization not usually within the short-run control of top management.

Internal strategic factors Strengths (core competencies) and weaknesses that are likely to determine whether a firm will be able take advantage of opportunities while avoiding threats.

International transfer pricing A method of minimizing taxes by declaring high profits in a subsidiary located in a country with a low tax rate and small profits in a subsidiary located in a country with a high tax rate.

Intranet An information network within an organization that also has access to the Internet.

Investment center A unit in which performance is measured in terms of the difference between the unit's resources and its services or products.

ISO 9000 Standards Series An internationally accepted way of objectively documenting a company's high level of quality operations.

ISO 14000 Standards Series An internationally accepted way to document a company's impact on the environment.

Issues priority matrix A chart that ranks the probability of occurrence versus the probable impact on the corporation of developments in the external environment.

Job characteristics model An approach to job design that is based on the belief that tasks can be described in terms of certain objective characteristics and that those characteristics affect employee motivation.

Job design The design of individual tasks in an attempt to make them more relevant to the company and more motivating to the employee.

Job enlargement Combining tasks to give a worker more of the same type of duties to perform.

Job enrichment Altering jobs by giving the worker more autonomy and control over activities.

Job rotation Moving workers through several jobs to increase variety.

Job shop One-of-a-kind production using skilled labor.

Joint venture An independent business entity created by two or more companies in a strategic alliance.

Justice approach An ethical approach that proposes that decision makers be equitable, fair, and impartial in the distribution of costs and benefits.

Just-In-Time A purchasing concept in which parts arrive at the plant just when they are needed rather than being kept in inventories.

Key performance measures Essential measures for achieving a desired strategic option—used in the balanced scorecard.

Key success factors Variables that significantly affect the overall competitive position of a company within a particular industry.

Late movers Companies that enter a new market only after other companies have done so.

Law A formal code that permits or forbids certain behaviors.

Lead director An outside director who calls meetings of the outside board members and coordinates the annual evaluation of the CEO.

Lead user A customer who is ahead of market trends and has needs that go beyond those of the average user.

Leading Providing direction to employees to use their abilities and skills most effectively and efficiently to achieve organizational objectives.

Lean Six Sigma A program incorporating the statistical approach of Six Sigma with the lean manufacturing program developed by Toyota.

Learning organization An organization that is skilled at creating, acquiring, and transferring knowledge and at modifying its behavior to reflect new knowledge and insights.

Levels of moral development Kohlberg proposed three levels of moral development: preconventional, conventional, and principled.

Leverage ratio An evaluation of how effectively a company utilizes its resources to generate revenues.

Leveraged buy-out An acquisition in which a company is acquired in a transaction financed largely by debt—usually obtained from a third party, such as an insurance company or an investment banker.

Licensing arrangement An agreement in which the licensing firm grants rights to another firm in another country or market to produce and/or sell a branded product.

Lifestyle company A small business in which the firm is purely an extension of the owner's lifestyle.

Line extension Using a successful brand name on additional products, such as Arm & Hammer brand first on baking soda, then on laundry detergents, toothpaste, and deodorants.

Linkage The connection between the way one value activity (for example, marketing) is performed and the cost of performance of another activity (for example, quality control).

Liquidation The termination of a firm in which all its assets are sold.

Liquidity ratio The percentage showing to what degree a company can cover its current liabilities with its current assets.

Logical incrementalism A decision-making mode that is a synthesis of the planning, adaptive, and entrepreneurial modes.

Logistics strategy A functional strategy that deals with the flow of products into and out of the manufacturing process.

Long-term contract Agreements between two separate firms to provide agreed-upon goods and services to each other for a specified period of time.

Long-term evaluation method A method in which managers are compensated for achieving objectives set over a multiyear period.

Long-term orientation (LT) The extent to which society is oriented toward the long term versus the short term.

Lower cost strategy A strategy in which a company or business unit designs, produces, and markets a comparable product more efficiently than its competitors.

Management audit A technique used to evaluate corporate activities.

Management By Objectives (MBO) An organization-wide approach ensuring purposeful action toward mutually agreed-upon objectives.

Management contract Agreements through which a corporation uses some of its personnel to assist a firm in another country for a specified fee and period of time.

Market development A marketing functional strategy in which a company or business unit captures a larger share of an existing market for current products through market penetration or develops new markets for current products.

Market location tactics Tactics that determine where a company or business unit will compete.

Market position Refers to the selection of specific areas for marketing concentration and can be expressed in terms of market, product, and geographical locations.

Market research A means of obtaining new product ideas by surveying current or potential users regarding what they would like in a new product.

Market segmentation The division of a market into segments to identify available niches.

Market value added (MVA) The difference between the market value of a corporation and the capital contributed by shareholders and lenders.

Marketing mix The particular combination of key variables (product, place, promotion, and price) that can be used to affect demand and to gain competitive advantage.

Marketing strategy A functional strategy that deals with pricing, selling, and distributing a product.

Masculinity-femininity (MF) The extent to which society is oriented toward money and things.

Mass customization The low-cost production of individually customized goods and services.

Mass production A system in which employees work on narrowly defined, repetitive tasks under close supervision in a bureaucratic and hierarchical structure to produce a large amount of low-cost, standard goods and services.

Matrix of change A chart that compares target practices (new programs) with existing practices (current activities).

Matrix structure A structure in which functional and product forms are combined simultaneously at the same level of the organization.

Mercosur/Mercosul South American free-trade area including Argentina, Brazil, Uruguay, and Paraguay.

Merger A transaction in which two or more corporations exchange stock, but from which only one corporation survives.

Mission The purpose or reason for an organization's existence.

Mission statement The definition of the fundamental, unique purpose that sets an organization apart from other firms of its type and identifies the scope or domain of the organization's operations in terms of products (including services) offered and markets served.

Modular manufacturing A system in which preassembled subassemblies are delivered as they are needed to a company's assembly-line workers who quickly piece the modules together into finished products.

Moore's law An observation of Gordon Moore, co-founder of Intel, that microprocessors double in complexity every 18 months.

Moral relativism A theory that proposes that morality is relative to some personal, social, or cultural standard, and that there is no method for deciding whether one decision is better than another.

Morality Precepts of personal behavior that are based on religious or philosophical grounds.

Most favored nation A policy of the World Trade Organization stating that a member country cannot grant one trading partner lower customs duties without granting them to all WTO member nations.

Multidomestic industry An industry in which companies tailor their products to the specific needs of consumers in a particular country.

Multinational corporation (MNC) A company that has significant assets and activities in multiple countries.

Multiple sourcing A purchasing strategy in which a company orders a particular part from several vendors.

Multipoint competition A rivalry in which a large multibusiness corporation competes against other large multibusiness firms in a number of markets.

Mutual service consortium A partnership of similar companies in similar industries that pool their resources to gain a benefit that is too expensive to develop alone.

Natural environment That part of the external environment that includes physical resources, wildlife, and climate that are an inherent part of existence on Earth.

Net present value (NPV) A calculation of the value of a project that is made by predicting the project's payouts, adjusting them for risk, and subtracting the amount invested.

Network structure An organization (virtual organization) that outsources most of its business functions.

New entrants Businesses entering an industry that typically bring new capacity to an industry, a desire to gain market share, and substantial resources.

New product experimentation A method of test marketing the potential of innovative ideas by developing products, probing potential markets with early versions of the products, learning from the probes, and probing again.

No-change strategy A decision to do nothing new; to continue current operations and policies for the foreseeable future.

North American Free Trade Agreement (NAFTA) Regional free trade agreement between Canada, the United States, and Mexico.

Not-for-profit organization Private nonprofit corporations and public governmental units or agencies.

Objectives The end result of planned activity stating what is to be accomplished by when, and quantified if possible.

Offensive tactic A tactic that calls for competing in an established competitor's current market location.

Offshoring The outsourcing of an activity or function to a provider in another country.

Open innovation A new approach to R&D in which a firm uses alliances and connections with corporate, government, and academic labs to learn about new developments.

Operating budget A budget for a business unit that is approved by top management during strategy formulation and implementation.

Operating cash flow The amount of money generated by a company before the costs of financing and taxes are figured.

Operating leverage The impact of a specific change in sales volume on net operating income.

Operations strategy A functional strategy that determines how and where a product or service is to be manufactured, the level of vertical integration in the production process, and the deployment of physical resources.

Opportunity A strategic factor considered when using the SWOT analysis.

Orchestrator A top manager who articulates the need for innovation, provides funding for innovating activities, creates incentives for middle managers to sponsor new ideas, and protects idea/product champions from suspicious or jealous executives.

Organization slack Unused resources within an organization.

Organizational analysis Internal scanning concerned with identifying an organization's strengths and weaknesses.

Organizational learning theory A theory proposing that an organization adjusts to changes in the environment through the learning of its employees.

Organizational life cycle How organizations grow, develop, and eventually decline.

Organizational structure The formal setup of a business corporation's value chain components in terms of work flow, communication channels, and hierarchy.

Output control A control that specifies what is to be accomplished by focusing on the end result of the behaviors through the use of objectives and performance targets.

Outside directors Members of a board of directors who are not employees of the board's corporation; also called non–management directors.

Outsourcing A process in which resources are purchased from others through long-term contracts instead of being made within the company.

Parallel sourcing A process in which two suppliers are the sole suppliers of two different parts, but they are also backup suppliers for each other's parts.

Pattern of influence A concept stating that influence in strategic management derives from a not-for-profit organization's sources of revenue.

Pause/proceed with caution strategy A corporate strategy in which nothing new is attempted; an opportunity to rest before continuing a growth or retrenchment strategy.

Penetration pricing A marketing pricing strategy to obtain dominant market share by using low price.

Performance The end result of activities, actual outcomes of a strategic management process.

Performance appraisal system A system to systematically evaluate employee performance and promotion potential.

Performance gap A performance gap exists when performance does not meet expectations.

Periodic statistical report Reports summarizing data on key factors such as the number of new customer contracts, volume of received orders, and productivity figures.

Phases of strategic management A set of four levels of development through which a firm generally evolves into strategic management.

Piracy The making and selling counterfeit copies of well-known name-brand products, especially software.

Planning mode A decision-making mode that involves the systematic gathering of appropriate information for situation analysis, the generation of feasible alternative strategies, and the rational selection of the most appropriate strategy.

Policy A broad guideline for decision making that links the formulation of strategy with its implementation.

Political strategy A strategy to influence a corporation's stakeholders.

Population ecology A theory that proposes that once an organization is successfully established in a particular environmental niche, it is unable to adapt to changing conditions.

Portfolio analysis An approach to corporate strategy in which top management views its product lines and business units as a series of investments from which it expects a profitable return.

Power distance (PD) The extent to which a society accepts an unequal distribution of influence in organizations.

Prediction markets A forecasting technique in which people make bets on the likelihood of a particular event taking place.

Pressure-cooker crisis A situation that exists when employees in collaborative organizations eventually grow emotionally and physically exhausted from the intensity of teamwork and the heavy pressure for innovative solutions.

Primary activity A manufacturing firm's corporate value chain, including inbound logistics, operations process, outbound logistics, marketing and sales, and service.

Primary stakeholders A high priority group that affects or is affected by the achievement of a firm's objectives.

Prime interest rate The rate of interest banks charge on their lowest-risk loans.

Private nonprofit corporation A nongovernmental not-for-profit organization.

Privatization The selling of state-owned enterprises to private individuals. Also the hiring of a private business to provide services previously offered by a state agency.

Procedures A list of sequential steps that describe in detail how a particular task or job is to be done.

Process innovation Improvement to the making and selling of current products.

Product champion A person who generates a new idea and supports it through many organizational obstacles.

Product development A marketing strategy in which a company or unit develops new products for existing markets or develops new products for new markets.

Product innovation The development of a new product or the improvement of an existing product's performance.

Product life cycle A graph showing time plotted against sales of a product as it moves from introduction through growth and maturity to decline.

Product R&D Research and development concerned with product or product-packaging improvements.

Product/market evolution matrix A chart depicting products in terms of their competitive positions and their stages of product/market evolution.

Product-group structure A structure of a multinational corporation that enables the company to introduce and manage a similar line of products around the world.

Production sharing The process of combining the higher labor skills and technology available in developed countries with the lower-cost labor available in developing countries.

Professional liquidator An individual called on by a bankruptcy court to close a firm and sell its assets.

Profit center A unit's performance, measured in terms of the difference between revenues and expenditures.

Profit strategy A strategy that artificially supports profits by reducing investment and short-term discretionary expenditures.

Profitability ratios Ratios evaluating a company's ability to make money over a period of time.

Profit-making firm A firm depending on revenues obtained from the sale of its goods

and services to customers, who typically pay for the costs and expenses of providing the product or service plus a profit.

Program A statement of the activities or steps needed to accomplish a single-use plan in strategy implementation.

Propitious niche A portion of a market that is so well suited to a firm's internal and external environment that other corporations are not likely to challenge or dislodge it.

Public governmental unit or agency A kind of not-for-profit organization that is established by government or governmental agencies (such as welfare departments, prisons, and state universities).

Public or collective good Goods that are freely available to all in a society.

Pull strategy A marketing strategy in which advertising pulls the products through the distribution channels.

Punctuated equilibrium A point at which a corporation makes a major change in its strategy after evolving slowly through a long period of stability.

Purchasing power parity (PPP) A measure of the cost, in dollars, of the U.S.-produced equivalent volume of goods that another nation's economy produces.

Purchasing strategy A functional strategy that deals with obtaining the raw materials, parts, and supplies needed to perform the operations functions.

Push strategy A marketing strategy in which a large amount of money is spent on trade promotion in order to gain or hold shelf space in retail outlets.

Quality of work life A concept that emphasizes improving the human dimension of work to improve employee satisfaction and union relations.

Quasi-integration A type of vertical growth/integration in which a company does not make any of its key supplies but purchases most of its requirements from outside suppliers that are under its partial control.

Question marks New products that have potential for success and need a lot of cash for development.

RFID A technology in which radio frequency identification tags containing product information is used to track goods through inventory and distribution channels.

R&D intensity A company's spending on research and development as a percentage of sales revenue.

R&D mix The balance of basic, product, and process research and development.

R&D strategy A functional strategy that deals with product and process innovation.

Ratio analysis The calculation of ratios from data in financial statements to identify possible strengths or weaknesses.

Real options approach An approach to new project investment when the future is highly uncertain.

Red flag An indication of a serious underlying problem.

Red tape crisis A crisis that occurs when a corporation has grown too large and complex to be managed through formal programs.

Reengineering The radical redesign of business processes to achieve major gains in cost, service, or time.

Regional industry An industry in which multinational corporations primarily coordinate their activities within specific geographic areas of the world.

Relationship-based governance A government system perceived to be less transparent and have a higher degree of corruption.

Repatriation of profits The transfer of profits from a foreign subsidiary to a corporation's headquarters.

Replicability The ability of competitors to duplicate resources and imitate another firm's success.

Resources A company's physical, human, and organizational assets that serve as the building blocks of a corporation.

Responsibility center A unit that is isolated so that it can be evaluated separately from the rest of the corporation.

Retired executive directors Past leaders of a company kept on the board of directors after leaving the company.

Retrenchment strategy Corporate strategies to reduce a company's level of activities and to return it to profitability.

Return on equity (ROE) A measure of performance that is calculated by dividing net income by total equity.

Return on investment (ROI) A measure of performance that is calculated by dividing net income before taxes by total assets.

Revenue center A responsibility center in which production, usually in terms of unit or dollar sales, is measured without consideration of resource costs.

Reverse engineering Taking apart a competitor's product in order to find out how it works.

Reverse stock split A stock split in which an investor's shares are reduced for the same total amount of money.

Risk A measure of the probability that one strategy will be effective, the amount of assets the corporation must allocate to that strategy, and the length of time the assets will be unavailable.

Rule-based governance A governance system based on clearly stated rules and procedures.

Rules of thumb Approximations based not on research, but on years of practical experience.

Sarbanes-Oxley Act Legislation passed by the U.S. Congress in 2002 to promote and formalize greater board independence and oversight.

Scenario box A tool for developing corporate scenarios in which historical data are used to make projections for generating pro forma financial statements.

Scenario writing A forecasting technique in which focused descriptions of different likely futures are presented in a narrative fashion.

Secondary stakeholders Lower-priority groups that affect or are affected by the achievement of a firm's objectives.

Sell-out strategy A retrenchment option used when a company has a weak competitive position resulting in poor performance.

Separation A method of managing the culture of an acquired firm in which the two companies are structurally divided, without cultural exchange.

SFAS (Strategic Factors Analysis Summary) matrix A chart that summarizes an organization's strategic factors by combining the external factors from an EFAS table with the internal factors from an IFAS table.

Shareholder value The present value of the anticipated future stream of cash flows from a business plus the value of the company if it were liquidated.

Short-term orientation The tendency of managers to consider only current tactical or operational issues and ignore strategic ones.

Simple structure A structure for new entrepreneurial firms in which the employees tend to be generalists and jacks-of-all-trades.

Six Sigma A statistically-based program developed to identify and improve a poorly performing process.

Skim pricing A marketing strategy in which a company charges a high price while a product is novel and competitors are few.

Small-business firm An independently owned and operated business that is not dominant in its field and that does not engage in innovative practices.

SO, ST, WO, WT strategies A series of possible business approaches based on combinations of opportunities, threats, strengths, and weaknesses.

Social capital The goodwill of key stakeholders, which can be used for competitive advantage.

Social entrepreneurship A business in which a not-for-profit organization starts a new venture to achieve social goals.

Social responsibility The ethical and discretionary responsibilities a corporation owes its stakeholders.

Societal environment Economic, technological, political-legal, and sociocultural environmental forces that do not directly touch on

the short-run activities of an organization but influence its long-run decisions.

Sole sourcing Relying on only one supplier for a particular part.

Sources of innovation Drucker's proposed seven sources of new ideas that should be monitored by those interested in starting entrepreneurial ventures.

Sponsor A department manager who recognizes the value of a new idea, helps obtain funding to develop the innovation, and facilitates the implementation of the innovation.

Stability strategy Corporate strategies to make no change to the company's current direction or activities.

Staffing Human resource management priorities and use of personnel.

Stages of corporate development A pattern of structural development that corporations follow as they grow and expand.

Stages of international development The stages through which international corporations evolve in their relationships with widely dispersed geographic markets and the manner in which they structure their operations and programs.

Stages of new product development The stages of getting a new innovation into the marketplace.

Stage-gate process A method of managing new product development to increase the likelihood of launching new products quickly and successfully. The process is a series of steps to move products through the six stages of new product development.

Staggered board A board on which directors serve terms of more than one year so that only a portion of the board of directors stands for election each year.

Stakeholder analysis The identification and evaluation of corporate stakeholders.

Stakeholder measure A method of keeping track of stakeholder concerns.

Stakeholder priority matrix A chart that categorizes stakeholders in terms of their interest in a corporation's activities and their relative power to influence the corporation's activities.

Stall point A point at which a company's growth in sales and profits suddenly stops and becomes negative.

Standard cost center A responsibility center that is primarily used to evaluate the performance of manufacturing facilities.

Standard operating procedures Plans that detail the various activities that must be carried out to complete a corporation's programs.

Star Market leader that is able to generate enough cash to maintain its high market share.

Statistical modeling A quantitative technique that attempts to discover causal or explanatory factors that link two or more time series together.

STEEP analysis An approach to scanning the societal environment that examines sociocultural, technological, economic, ecological, and political-legal forces. Also called PESTEL analysis.

Steering control Measures of variables that influence future profitability.

Stewardship theory A theory proposing that executives tend to be more motivated to act in the best interests of the corporation than in their own self-interests.

Strategic alliance A partnership of two or more corporations or business units to achieve strategically significant objectives that are mutually beneficial.

Strategic audit A checklist of questions by area or issue that enables a systematic analysis of various corporate functions and activities. It's a type a management audit.

Strategic audit worksheet A tool used to analyze a case.

Strategic business unit (SBU) A division or group of divisions composed of independent product-market segments that are given primary authority for the management of their own functions.

Strategic choice The evaluation of strategies and selection of the best alternative.

Strategic choice perspective A theory that proposes that organizations adapt to a changing environment and have the opportunity and power to reshape their environment.

Strategic decision-making process An eight-step process that improves strategic decision making.

Strategic decisions Decisions that deal with the long-run future of an entire organization and are rare, consequential, and directive.

Strategic factors External and internal factors that determine the future of a corporation.

Strategic flexibility The ability to shift from one dominant strategy to another.

Strategic group A set of business units or firms that pursue similar strategies and have similar resources.

Strategic inflection point The period in an organization's life in which a major change takes place in its environment and creates a new basis for competitive advantage.

Strategic management A set of managerial decisions and actions that determine the long-run performance of a corporation.

Strategic management model A rational, prescriptive planning model of the strategic management process including environmental scanning, strategy formulation, strategy implementation, and evaluation and control.

Strategic myopia The willingness to reject unfamiliar as well as negative information.

Strategic piggybacking The development of a new activity for a not-for-profit organization that would generate the funds needed to make up the difference between revenues and expenses.

Strategic planning staff A group of people charged with supporting both top management and business units in the strategic planning process.

Strategic R&D alliance A coalition through which a firm coordinates its research and development with another firm(s) to offset the huge costs of developing new technology.

Strategic rollup A means of consolidating a fragmented industry in which an entrepreneur acquires hundreds of owner-operated small businesses resulting in a large firm with economies of scale.

Strategic sweet spot A market niche in which a company is able to satisfy customers' needs in a way that competitors cannot.

Strategic type A category of firms based on a common strategic orientation and a combination of structure, culture, and processes that are consistent with that strategy.

Strategic vision A description of what the company is capable of becoming.

Strategic window A unique market opportunity that is available only for a particular time.

Strategic-funds method An evaluation method that encourages executives to look at development expenses as being different from expenses required for current operations.

Strategies to avoid Strategies sometimes followed by managers who have made a poor analysis or lack creativity.

Strategy A comprehensive plan that states how a corporation will achieve its mission and objectives.

Strategy formulation Development of long-range plans for the effective management of environmental opportunities and threats in light of corporate strengths and weaknesses.

Strategy implementation A process by which strategies and policies are put into action through the development of programs, budgets, and procedures.

Strategy-culture compatibility The match between existing corporate culture and a new strategy to be implemented.

Structure follows strategy The process through which changes in corporate strategy normally lead to changes in organizational structure.

Stuck in the middle A situation in which a company or business unit has not achieved a generic competitive strategy and has no competitive advantage.

Suboptimization A phenomenon in which a unit optimizes its goal accomplishment to the detriment of the organization as a whole.

Substages of small business development A set of five levels through which new ventures often develop.

Substitute products Products that appear to be different but can satisfy the same need as other products.

Supply-chain management The formation of networks for sourcing raw materials, manufacturing products or creating services, storing and distributing goods, and delivering goods or services to customers and consumers.

Support activity An activity that ensures that primary value-chain activities operate effectively and efficiently.

SWOT analysis Identification of strengths, weaknesses, opportunities, and threats that may be strategic factors for a specific company.

Synergy A concept that states that the whole is greater than the sum of its parts; that two units will achieve more together than they could separately.

Tacit knowledge Knowledge that is not easily communicated because it is deeply rooted in employee experience or in a corporation's culture.

Tactic A short-term operating plan detailing how a strategy is to be implemented.

Takeover A hostile acquisition in which one firm purchases a majority interest in another firm's stock.

Taper integration A type of vertical integration in which a firm internally produces less than half of its own requirements and buys the rest from outside suppliers.

Task environment The part of the business environment that includes the elements or groups that directly affect the corporation and, in turn, are affected by it.

Technological competence A corporation's proficiency in managing research personnel and integrating their innovations into its day-to-day operations.

Technological discontinuity The displacement of one technology by another.

Technological follower A company that imitates the products of competitors.

Technological leader A company that pioneers an innovation.

Technology sourcing A make-or-buy decision that can be important in a firm's R&D strategy.

Technology transfer The process of taking a new technology from the laboratory to the marketplace.

Time to market The time from inception to profitability of a new product.

Timing tactics Tactics that determines when a business will enter a market with a new product.

Tipping point The point at which a slowly changing situation goes through a massive, rapid change.

Top management responsibilities Leadership tasks that involve getting things accomplished through and with others in order to meet the corporate objectives.

Total Quality Management (TQM) An operational philosophy that is committed to customer satisfaction and continuous improvement.

TOWS matrix A matrix that illustrates how external opportunities and threats facing a particular company can be matched with that company's internal strengths and weaknesses to result in four sets of strategic alternatives.

Transaction cost economics A theory that proposes that vertical integration is more efficient than contracting for goods and services in the marketplace when the transaction costs of buying goods on the open market become too great.

Transfer price A practice in which one unit can charge a transfer price for each product it sells to a different unit within a company.

Transferability The ability of competitors to gather the resources and capabilities necessary to support a competitive challenge.

Transformational leader A leader who causes change and movement in an organization by providing a strategic vision.

Transparent The speed with which other firms can understand the relationship of resources and capabilities supporting a successful firm's strategy.

Trends in governance Current developments in corporate governance.

Trigger point The point at which a country has developed economically so that demand for a particular product or service is increasing rapidly.

Triggering event Something that acts as a stimulus for a change in strategy.

Turnaround specialist A manager who is brought into a weak company to salvage that company in a relatively attractive industry.

Turnaround strategy A plan that emphasizes the improvement of operational efficiency when a corporation's problems are pervasive but not yet critical.

Turnkey operation Contracts for the construction of operating facilities in exchange for a fee.

Turnover A term used by European firms to refer to sales revenue. It also refers to the amount of time needed to sell inventory.

Uncertainty avoidance (UA) The extent to which a society feels threatened by uncertain and ambiguous situations.

Union of South American Nations An organization formed in 2008 to unite Mercosur and the Andean Community.

Utilitarian approach A theory that proposes that actions and plans should be judged by their consequences.

Value chain A linked set of value-creating activities that begins with basic raw materials coming from suppliers and ends with distributors getting the final goods into the hands of the ultimate consumer.

Value-chain partnership A strategic alliance in which one company or unit forms a long-term arrangement with a key supplier or distributor for mutual advantage.

Value disciplines An approach to evaluating a competitor in terms of product leadership, operational excellence, and customer intimacy.

Vertical growth A corporate growth strategy in which a firm takes over a function previously provided by a supplier or distributor.

Vertical integration The degree to which a firm operates in multiple locations on an industry's value chain from extracting raw materials to retailing.

Virtual organization An organizational structure that is composed of a series of project groups or collaborations linked by changing nonhierarchical, cobweb-like networks.

Virtual team A group of geographically and/or organizationally dispersed coworkers that are assembled using a combination of telecommunications and information technologies to accomplish an organizational task.

Vision A view of what management thinks an organization should become.

VRIO framework Barney's proposed analysis to evaluate a firm's key resources in terms of value, rareness, imitability, and organization.

Web 2.0 A term used to describe the evolution of the Internet into wikis, blogs, RSS, social networks, podcasts, and mash-ups.

Weighted-factor method A method that is appropriate for measuring and rewarding the performance of top SBU managers and group-level executives when performance factors and their importance vary from one SBU to another.

Whistle-blower An individual who reports to authorities incidents of questionable organizational practices.

World Trade Organization A forum for governments to negotiate trade agreements and settle trade disputes.

Z-value A formula that combines five ratios by weighting them according to their importance to a corporation's financial strength to predict the likelihood of bankruptcy.

NOTE: This glossary contains terms used in the twelve chapters of this textbook plus the three additional chapters provided on the publisher's Web site to buyers of this book.

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