Second Edition

Essentials of Strategic Management

The Quest for Competitive Advantage

John E. Gamble

Arthur A. Thompson Jr.

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2nd Edition

John E. Gamble
University of South Alabama

Arthur A. Thompson, Jr.
The University of Alabama

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Aboutthe A uthors

John E. Gamble is currently a Professor of Management in the Mitchell College of Business at the University of South Alabama. His teaching specialty at USA is strategic management and he also conducts a course in strategic management in Germany, which is sponsored by the University of Applied Sciences in Worms.

Dr. Gamble's research interests center on strategic issues in entrepreneurial, health care, and manufacturing settings. His work has been published in various scholarly journals and he is the author or co-author of more than 50 case studies published in an assortment of strategic management and strategic marketing texts. He has done consulting on industry and market analysis for clients in a diverse mix of industries.

Professor Gamble received his Ph.D. in management from The University of Alabama in 1995. Dr. Gamble also has a Bachelor of Science degree and a Master of Arts degree from The University of Alabama.

Arthur A. Thompson, Jr., earned his B.S. and Ph.D. degrees in economics from The University of Tennessee, spent three years on the economics faculty at Virginia Tech, and served on the faculty of The University of Alabama's College of Commerce and Business Administration for 25 years. In 1974 and again in 1982, Dr. Thompson spent semester-long sabbaticals as a visiting scholar at the Harvard Business School.

His areas of specialization are business strategy, competition and market analysis, and the economics of business enterprises. In addition to publishing over 30 articles in some 25 different professional and trade publications, he has authored or co-authored five textbooks and six computer-based simulation exercises that are used in colleges and universities worldwide.

Dr. Thompson spends much of his off-campus time giving presentations, putting on management development programs, working with companies, and helping operate a business simulation enterprise in which he is a major partner.

Dr. Thompson and his wife of 49 years have two daughters, two grandchildren, and a Yorkshire terrier.

The Business Strategy Game & GLO-BUS

Both BSG & GLO-BUS empower students to design a strategy aimed at winning a competitive advantage for their company in head-to-head competition against companies run by their classmates. Students apply textbook and lecture concepts while battling for market share and industry leadership. Both simulations are global in nature and have conceptually strong Assurance of Learning Reports that can be used to support accreditation by such bodies as the AACSB and ACBSP.

For more information, a virtual tour, or to sign up for live demo with the simulation authors, please visit www.mhhe.com/thompsonsims.

BSG & GLO-BUS are FUN, EFFECTIVE, and easy to implement.

Primis Online

McGraw-Hill's Primis Online gives you access to abundant resources, to the world's best at your fingertips. With a few mouse clicks, you can create customized learning tools simply and affordably. When you adopt a Primis Online text, you decide the best format for your students: **printed black-and-white** or **electronic books.**

McGraw-Hill's Primis Online includes most all of our market-leading textbooks, as well as the most extensive case collection available. We feature over 9,000 case studies from prominent case providers such as Harvard Business School Publishing, Ivey, Darden, and Thunderbird. We also offer exclusive McGraw-Hill cases through our Gamble/Thompson and Pinnacle collections. You are free to mix and match text and case content in whatever way best suits your students' needs. Some ideas to consider:

- Combine chapters from more than one McGraw-Hill textbook.
- Delete chapters that you do not cover.
- Include special readings or assignments with textbook chapters.
- Change the order of chapters to perfectly match your syllabus.
- Add your syllabus, lecture notes, or PowerPoints to the textbook.
- Combine chapters from the Study Guide to the custom book.

For your convenience we have cross-referenced the cases throughout our collection and organized them both topically and alphabetically. Details on the origins of the cases are found in the source information.

If you are looking for a particular case by name or number, use the search function at the top right of the screen.

Feel free to use the Primis site to do any of these things now at: http://www.primisonline.com or http://www.primisonline.com/thompson. Build as many complimentary books as you like. There is no obligation. Printed books will arrive at your door in about a week. Ebooks take only about 24 hours.

If you adopt a printed version, students can purchase the text through your local campus bookstore.

If you adopt an electronic book, students can buy their course materials online from our eBookstore at http://ebooks.primisonline.com.

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Preface

The standout features of this Second Edition of *Essentials of Strategic Management* are its concisely written and robust coverage of strategic management concepts and its compelling collection of cases. The text responds to growing requests by business faculty for a concise, conceptually strong treatment of strategic management principles and analytic approaches that features straight-to-the-point discussions, timely examples, and a writing style that captures the interest of students. This edition was crafted with four objectives in mind:

1. To fully engage students in the task of learning what every aspiring manager needs to know about the theory and practice of strategic management.
2. To provide an attractive set of contemporary cases that involve headline strategic issues and that give students ample opportunities to apply what they read in the chapters.
3. To complement the use of a business strategy simulation.
4. To simplify the task of demonstrating student learning through course-embedded assessment.

Changes, Improvements, and Differentiating Features

As in any substantive revision, the chapter coverage has been trimmed in some areas, expanded in others. The most easily recognized changes include the order of the chapters, which have been reorganized to match the organization of the 17th edition of our full-length text, *Crafting & Executing Strategy,* and the addition of a new chapter examining business strategies used to supplement the chosen competitive strategy. As always, much effort has gone into refining the explanations of core concepts and analytical tools, updating and refreshing the examples, and including the latest research findings pertinent to a first course in strategy. The fundamental character of the Second Edition of *Essentials of Strategic Management* is very much in step with the best academic thinking and contemporary management practice.

Complementing the text presentation is a truly appealing lineup of 15 diverse, timely, and thoughtfully crafted cases. All of the cases are tightly linked to the content of the 10 chapters, thus pushing students to apply the concepts and analytical tools they have read about. Nine of the 15 cases were written by the co-authors to illustrate specific tools of analysis or distinct strategic management theories. The six cases included in the text not written by the co-authors were chosen because of their exceptional linkage to strategic management concepts presented in the text. We are confident you will be impressed with how well each of the 15 cases in the collection will work in the classroom and the amount of student interest they will spark.

This book by no means "requires" parallel use of a simulation, but it fits the needs of simulation users perfectly. The relatively short length of each chapter gives students more time for exploring how best to utilize and apply the chapter material in operating their simulation company, actually crafting a strategy for their company, and becoming more savvy about making good strategy-related decisions. In addition, each chapter contains an Exercise for Simulation Participants designed to drive home the linkage between the strategic management concepts presented in the chapter and the decision-making challenges of running a simulation company in a globally competitive marketplace.

Through our experiences as college of business faculty members, we also fully understand the assessment demands on faculty teaching strategic management courses. In many institutions, capstone courses have emerged as the logical home for assessing student achievement of program learning objectives. *Essentials of Strategic Management* includes a number of interesting Assurance of Learning Exercises at the end of each chapter that you can use as a basis for class discussion or to demonstrate student learning through written assignments and/or team presentations. Instructors can easily pair the Assurance of Learning Exercises with instructor-developed scoring rubrics to assess course or program learning outcomes.

And there's an array of support materials in the Instructor Resources package to equip you with enormous course design flexibility and a powerful kit of teaching/learning tools. We've done our very best to ensure that the Second Edition package will work especially well for you in the classroom, help you economize on the time needed to be well prepared for each class, and cause students to conclude that your course is one of the very best they have ever taken—from the standpoint of both enjoyment and learning.

Differentiationf romO ther Texts

There are three noteworthy traits that strongly differentiate this text from others in the field:

1. *The coverage of resource-based theory of the firm in the Second Edition is unsurpassed by any other leading strategy text.* RBV principles and concepts are prominently and comprehensively integrated into our coverage of crafting both single-business and multibusiness strategies. In Chapters 1 through 8, it is repeatedly emphasized that a company's strategy must be matched *not only* to its external market circumstances *but also* to its internal resources and competitive capabilities. Moreover, an RBV perspective is integrated into the presentation on strategy execution (Chapter 10) to make it unequivocally clear how and why the tasks of assembling intellectual capital and building dynamic capabilities and core competencies

are absolutely critical to successful strategy execution and operating excellence.

2. *The coverage of business ethics, social responsibility, and environmental sustainability is unsurpassed by any other leading strategy text.* In this new edition, we have embellished the highly important chapter on "Ethical Business Strategies, Corporate Social Responsibility, and Environmental Sustainability" with fresh content so that it can better fulfill the important functions of (1) alerting students to the role and importance of ethical and socially responsible decision making and (2) addressing the accreditation requirements of the AACSB International that business ethics be visibly and thoroughly embedded in the core curriculum. Moreover, discussions of the importance of high ethical standards is integrated into portions of Chapters 2 and 10 to further reinforce why and how considerations relating to ethics, social responsibility, and sustainability should figure prominently into the managerial task of crafting and executing company strategies.
3. *The caliber of the case collection in the Second Edition is truly top-notch*f rom the standpoints of student appeal, being eminently teachable, and suitability for drilling students in the use of the concepts and analytical treatments in Chapters 1 through 10. The 15 cases included in this edition are the very latest, the best, and the most on-target that we could find. The ample information about the cases in the Instructor's Manual makes it effortless to select a set of cases each term that will capture the interest of students from start to finish.

Organization, Content, and Features of the 10 Text Chapters

The following rundown summarizes the topical focus of each *Essentials of StrategicM anagement*c hapter:

- Chapter 1 focuses on the central questions of *"Where are we now?" "Where do we want to go?" and "How are we going to get there?"* In putting these questions into the context of business strategy, we introduce students to the primary approaches to building competitive advantage and the key elements of business-level strategy. Following Henry Mintzberg's pioneering research, we also stress why a company's strategy is partly planned and partly reactive and why this strategy tends to evolve over time. The chapter also discusses why it is important for a company to have a *viable business model* that outlines the company's customer value proposition, its profit formula, and the key resources and processes required to create and deliver customer value. This brief chapter is the perfect accompaniment to your opening day lecture on what the course is all about and why it matters.
- Chapter 2 lays out a *five-stage strategic management process* and examines the role of leadership in setting the long-term direction of the company, crafting its strategy, and leading the execution process. Students are

introduced to such core concepts as strategic visions, mission statements, strategic versus financial objectives, business strategy, and corporate strategy. The chapter's treatment of objective setting is framed by the key tenets of Kaplan and Norton's Balanced Scorecard. Senior management's responsibility to lead the development of stronger competitive capabilities, display ethical integrity, and lead social responsibility initiatives is included in our discussion of *strategic leadership.* The chapter winds up with a section on *conditions for good corporate governance*an d examines conditions that led to recent high-profile corporate governance failures.

- Chapter 3 sets forth the now-familiar analytical tools and concepts of industry and competitive analysis and demonstrates the importance of tailoring strategy to fit the circumstances of a company's industry and competitive environment. *The standout feature of this chapter is a presentation of Michael Porter's "five forces model of competition" that we think is the clearest, most straightforward discussion of any text in the field.*
- Chapter 4 presents the *resource-based view of the firm* and convincingly argues why a company's strategy must be built around its competitively valuable capabilities and resources. Our discussion of the competitive value of a company's collection of resources and capabilities is framed by the tenets of the VRIN model. SWOT analysis is cast as a simple, easy-to-use way to take inventory of a company's resources and overall situation. There is solid coverage of value chain analysis, benchmarking, and competitive strength assessments—standard tools for appraising a company's relative cost position and market standing vis-à-vis rivals.
- Chapter 5 deals with a company's quest for competitive advantage as is framed around the *five generic competitive strategies*—overall low-cost leadership, broad differentiation, focused differentiation, focused low cost and best-costp rovider.
- An all-new Chapter 6 deals with the *business strategy options* available to complement a company's basic competitive strategy and improve its market position. The advantages and disadvantages of offensive strategies (including the benefits of a blue ocean strategy), defensive strategies, first-mover, fast-follower, and late-mover strategies are discussed. The chapter features sections on what use to make of strategic alliances and collaborative partnerships; merger and acquisition strategies; vertical integration strategies; and outsourcing strategies.
- Chapter 7 explores the full range of strategy options for competing in international markets: export strategies; licensing; franchising; localized multicountry strategies; global strategies; and collaborative strategies involving heavy reliance on strategic alliances and joint ventures. There's also coverage of strategy considerations in international markets, including a discussion of the unique characteristics of competing in emerging markets. Key topics in the discussion of how best to use international operations to improve overall competitiveness include locational advantages, cross-border coordination, and the use of profit sanctuaries in waging strategic offensives.

- Chapter 8 examines strategies for building shareholder value in multi-business enterprises. Corporate strategy topics covered in the chapter include methods of entering new businesses, related diversification, unrelated diversification, combined related and unrelated diversification approaches, and strategic options for improving the overall performance of an already diversified company. The chapter's analytical spotlight is trained on the techniques and procedures for assessing a diversified company's business portfolio—the relative attractiveness of the various industries the company has diversified into, the company's competitive strength in each of its business lines, and the *strategic fits* and *resource fits* among a diversified company's different businesses. The chapter concludes with a brief survey of a company's four main post-diversification strategy alternatives: (1) sticking closely with the existing business lineup, (2) broadening the diversification base, (3) divesting some businesses and retrenching to a narrower diversification base, and (4) restructuring the makeup of the company's business lineup.
- Chapter 9 reflects the very latest in the literature on (1) a company's *duty to operate according to ethical standards;* (2) a company's *obligation to demonstrate socially responsible behavior and corporate citizenship;* and (3) why more companies are *limiting strategic initiatives to those that meet the needs of consumers in a manner that protects natural resources and ecological support systems needed by future generations.* The opening section of the chapter outlines drivers of unethical strategies and business behavior and discusses the *business case supporting a strong commitment to business ethics.* This discussion includes approaches to ensuring consistent ethical standards for companies with international operations. Following this section, we discuss *corporate social responsibility and corporate citizenship theories*an d the growing efforts of corporations in many industries to limit strategies and operating practices to those that are *environmentally sustainable.*
- Chapter 10 is anchored around a pragmatic, compelling conceptual framework: (1) building dynamic capabilities, core competencies, resources, and structure necessary for proficient strategy execution; (2) allocating ample resources to strategy-critical activities; (3) ensuring that policies and procedures facilitate rather than impede strategy execution; (4) pushing for continuous improvement in how value chain activities are performed; (5) installing information and operating systems that enable company personnel to better carry out essential activities; (6) tying rewards and incentives directly to the achievement of performance targets and good strategy execution; (7) shaping the work environment and corporate culture to fit the strategy; and (8) exerting the internal leadership needed to drive execution forward.

  The recurring theme throughout the chapter is that implementing and executing strategy entails figuring out the specific actions, behaviors, and conditions that are needed for a smooth strategy-supportive operation—the goal here is to ensure that students understand that the strategy-implementing/strategy-executing phase is a make-it-happen-right kind of managerial exercise that leads to operating excellence and good performance.

We have done our best to ensure that the 10 chapters convey the best thinking of academics and practitioners in the field of strategic management and hit the bull's-eye in topical coverage for senior- and MBA-level strategy courses. We are confident you'll find the 10-chapter presentation is among the best strategic management texts in terms of coverage, readability, quality illustrations, and carefully crafted case studies. The ultimate test of the text, of course, is the positive pedagogical impact it has in the classroom. If this text sets a more effective stage for your lectures and does a better job of helping you persuade students that the discipline of strategy merits their rapt attention, then it will have fulfilled its purpose.

The CaseC ollection

Essentials of Strategic Management, Second Edition, features a case collection flush with interesting companies and valuable lessons for students in the art and science of crafting and executing strategy. There's a good blend of cases from a length perspective—about a third are under 15 pages, yet offer plenty for students to chew on; about a third are medium-length cases; and the remaining third are detail-rich cases that call for more sweeping analysis.

At least 13 of the 15 cases involve companies, products, or people that students will have heard of, know about from personal experience, or can easily identify with. The lineup includes at least six cases that will provide students with insight into the special demands of competing in industry environments where technological developments are an everyday event, product life cycles are short, and competitive maneuvering among rivals comes fast and furious. The effect of the international economic downturn that began in December 2007 and continued into 2009 is presented as a front-burner strategic issue in 8 of the 15 cases. Thirteen of the cases involve situations where company resources and competitive capabilities play as large a role in the strategy-making, strategy-executing scheme of things as industry and competitive conditions do. Scattered throughout the lineup are eight cases concerning non-U.S. companies, globally competitive industries, and/or cross-cultural situations; these cases, in conjunction with the globalized content of the text chapters, provide abundant material for linking the study of strategic management tightly to the ongoing globalization of the world economy. Twelve cases involve public companies about which students can do further research on the Internet. Five of the cases have accompanying video segments: Competition in the Movie Rental Industry in 2008, Dell, Inc. in 2008, Google's Strategy in 2009, Walmart Stores, Inc. in 2008, and Southwest Airlines in 2008.

We believe you will find the collection of 15 cases quite appealing, eminently teachable, and very suitable for drilling students in the use of the concepts and analytical treatments in Chapters 1 through 10. With this case lineup, you should have no difficulty whatsoever assigning cases that will capture the interest of students from start to finish.

The Two Companion Strategy Simulations

The Business Strategy Game and *GLO-BUS: Developing Winning Competitive Strategies*—two Web-based strategy simulations that feature automated decision processing and performance grading—are being marketed by the publisher as companion supplements for use with this and other texts in the field. *The Business Strategy Game* is the world's leading strategy simulation, having been played by over 500,000 students at 600-plus universities worldwide. *GLO-BUS,* a somewhat streamlined online strategy simulation that was introduced in 2004, has been played by over 50,000 students at more than 150 universities across the world. Both simulations allow students to apply strategy making and analysis concepts presented in the text and may be used as part of a comprehensive effort to assess undergraduate or graduate program learning objectives.

The Compelling Case for Incorporating a Strategy Simulation

There are four powerful, convincing reasons for using a simulation in strategy courses for seniors and MBA students:

- Assigning students to run a company that competes head-to-head against companies run by other class members *gives students the immediate opportunity to experiment with various strategy options and to gain proficiency in applying the core concepts and analytical tools that they have been reading about.*
- *A competition-based strategy simulation adds an enormous amount of student interest and excitement.* Being an active manager in running a company in which they have a stake makes the students' task of learning about crafting and executing winning strategies more enjoyable. Their company becomes "real" and takes on a life of its own as the simulation unfolds—and it doesn't take long for students to establish a healthy rivalry with other class members who are running rival companies.
- Strategy simulations like *The Business Strategy Game* or *GLO-BUS*t hat have exceptionally close ties between the industry and company circumstances in the simulation and the topics covered in the text chapters *provide instructors with a host of first-rate examples of how the material in the text applies both to the simulation experience and to real-world management.*
- Because a simulation involves making decisions related to production operations, worker compensation and training, sales and marketing, distribution, customer service, and finance and requires analysis of company financial statements and market data, *the simulation helps students synthesize the knowledge gained in a variety of different business courses. The cross-functional, integrative nature of a strategy simulation helps make courses in strategy much more of a true capstone experience.*

In sum, *a three-pronged text-case-simulation course model has significantly more teaching/learning power than the traditional text-case model.* And, happily, there's another positive side-benefit to using a simulation—*it lightens the grading burden for instructors.* Most adopters trim the total number of assigned cases to allow for classroom time to explain the mechanics of the simulation and to challenge students about the strength of their competitive advantage and what changes might be considered to their strategies or operations. This results in less time spent grading because both *The Business Strategy Game* and *GLO-BUS* have built-in grading features that require no instructor effort (beyond setting the grading weights).

Administration and Operating Features of the Two Companion Simulations

The Internet delivery and user-friendly designs of both *BSG* and *GLO-BUS* make them incredibly easy to administer, even for first-time users. And the menus and controls are so similar that you can readily switch between the two simulations or use one in your undergraduate class and the other in a graduate class. If you have not yet used either of the two simulations, you may find the following of particular interest:

- Time requirements for instructors are minimal. Setting up the simulation for your course is done online and takes about 10–15 minutes. Once set-up is completed, no other administrative actions are required beyond that of moving participants to a different team (should the need arise) and monitoring the progress of the simulation (to whatever extent desired).
- There's no software for students or administrators to download and no disks to fool with. All work must be done online and the speed for participants using dial-up modems is quite satisfactory. The servers dedicated to hosting the two simulations have appropriate back-up capability and are maintained by a prominent Web-hosting service that guarantees 99.99% reliability on a 24/7/365 basis—as long as students or instructors are connected to the Internet, the servers are virtually guaranteed to be operational.
- Participant's Guides are delivered at the Web site—students can read it on their monitors or print out a copy, as they prefer.
- There are extensive built-in "Help" screens explaining (a) each decision entry, (b) the information on each page of the Industry Reports, and (c) the numbers presented in the Company Reports. *The Help screens allow company co-managers to figure things out for themselves, thereby curbing the need for students to always run to the instructor with questions about "how things work."*
- The results of each decision are processed automatically and are typically available to all participants *15 minutes* after the decision deadline specified by the instructor/game administrator.
- Participants and instructors are notified via e-mail when the results are ready.
- Decision schedules are instructor-determined. Decisions can be made once per week, twice per week, or even twice daily, depending on how instructors want to conduct the exercise. One popular decision schedule involves one or two practice decisions and 6–10 weekly decisions across the remainder of the term. A second popular schedule is one or two practice decisions during weeks three and four of the course, followed by two decisions per week during the last four to six weeks of the course. A third popular schedule is to use the simulation as a "final written assignment"

for the course, where student teams are required to prepare a report discussing their strategy, operations, and performance during the simulation. The simulation is also well suited to executive courses where five to eight decisions are made over a three- to five-day period.

- Instructors have the flexibility to prescribe 0, 1, or 2 practice decisions and from 4 to 10 regular decisions.
- Company teams can be composed of one to five players each and the number of companies competing head-to-head in a single industry can range from 4 to 12. If your class size is too large for a single industry, then it is a simple matter to create two or more industries for a single class section.
- Following each decision round, participants are provided with a complete set of reports—a six-page Industry Report, a one-page Competitive Intelligence report for each geographic region that includes strategic group maps and bulleted lists of competitive strengths and weaknesses, and a set of Company Reports (income statement, balance sheet, cash flow statement, and assorted production, marketing, and cost statistics).
- Two "open-book" multiple choice tests of 20 questions (optional, but strongly recommended) are included as part of each of the two simulations. The quizzes are taken online and automatically graded, with scores reported instantaneously to participants and automatically recorded in the instructor's electronic grade book. Students are provided with three sample questions for each test.
- Both simulations contain a three-year strategic plan option that you can assign. Scores on the plan are automatically recorded in the instructor's online grade book.
- At the end of the simulation, you can have students complete online peer evaluations (again, the scores are automatically recorded in your online gradeb ook).
- Both simulations have a Company Presentation feature that enables students to easily prepare PowerPoint slides for use in describing their strategy and summarizing their company's performance in a presentation either to the class, the instructor, or an "outside" board of directors.
- *A Learning Assurance Report provides you with hard data concerning how well your students performed vis-à-vis students who have participated in the simulation exercise worldwide during the past 12 months.* The report is based on nine measures of student proficiency, business know-how, and decision-making skill and can also be used in evaluating the extent to which your school's academic curriculum produces the desired degree of student learning insofar as accreditation standards are concerned.

For more details on either simulation, please consult the Instructor's Manual or visit the simulation Web sites (**www.bsg-online.com** and **www.glo-bus.com**). Once you register (there's no obligation), you'll be able to access the Instructor's Guide and a set of PowerPoint Presentation slides that you can skim to preview the two simulations in some depth. The simulation authors will be glad to provide you with a personal tour of either or both Web sites (while you are on your PC) and walk you through the many features that are built into the simulations. You can arrange such a demonstration by signing up at **http://formdesk.com/mhhe/strategy** or by contacting the simulation authors at **(205) 722-9140**. We think you'll be quite impressed with the capabilities that have been programmed into *The Business Strategy Game* and *GLO-BUS*, the simplicity with which both simulations can be administered, and their exceptionally tight connection to the text chapters, core concepts, and standard analytical tools.

Adopters of the text who also want to incorporate use of one of the two simulation supplements can either have students register at the simulation Web site via a credit card or instruct the campus bookstore to order the "book-simulation package"—the publisher has a special ISBN number for new texts that contain a special card shrink-wrapped with each text; printed on the enclosed card is a prepaid access code that students can use to register for either simulation and gain full access to the student portion of the simulation Web site.

Student Support Materials

Key Points Summaries

At the end of each chapter is a synopsis of the core concepts, analytical tools, and other key points discussed in the chapter. These chapter-end synopses help students focus on basic strategy principles, digest the messages of each chapter, and prepare for tests.

Two Sets of Chapter-End Exercises

Each chapter concludes with two sets of exercises: The Assurance of Learning Exercises can be used as the basis for class discussion, oral presentation assignments, short written reports, and substitutes for case assignments. The Exercises for Simulation Participants are designed expressly for use by adopters who have incorporated use of a simulation and wish to go a step further in tightly and explicitly connecting the chapter content to the simulation company their students are running. The questions in both sets of exercises (along with Concepts & Connections illustrations that qualify as "mini-cases") can be used to round out the rest of a 75-minute class period should your lecture on a chapter last for only 50 minutes.

Online Learning Center (OLC)

The following helpful aids are available to students via the publisher's OLC at **www.mhhe.com/gamble2e**:

- **Case Assignment Questions** Each of the 15 cases in the text is accompanied by a set of assignment questions that match the teaching outline and analysis section of the case teaching notes provided in the Instructor's Manual. The assignment questions provided for each case coach students in doing the strategic thinking needed to develop sound analysis-based recommendations that address the strategic issues presented in that case. Conscientious completion of the case assignment questions helps students gain quicker command of the concepts and analytical techniques and points them toward doing good strategic analysis.

- **Self-Graded Chapter Quizzes** The OLC contains 20-question quizzes for each chapter to allow students to measure their grasp of the material presented in each of the 10 chapters.
- **Guide to Case Analysis** Explains what a case is, why cases are a standard part of courses in strategy, how to prepare for a class discussion of a case, how to prepare a written case analysis, what is expected in an oral presentation, and how to use financial ratio analysis to assess a company's financial condition. We suggest having students read this Guide prior to the first class discussion of a case.
- **PowerPoint slides**f or each chapter.

Instructor Support Materials

Online Learning Center (OLC)

In addition to the student resources, the instructor section of **www.mhhe.com/gamble2e** also includes the Instructor's Manual and other instructional resources. Your McGraw-Hill representative can arrange delivery of instructor support materials in a format-ready Standard Cartridge for Blackboard, WebCT, and other Web-based educational platforms.

Instructor's Manual and Case Teaching Notes

The accompanying IM was prepared exclusively by the text co-authors. We've included a section on suggestions for organizing and structuring your course, sample syllabi and course outlines used by the co-authors, a set of lecture notes, a copy of the test bank, and comprehensive teaching notes for each of the cases. All of the teaching notes were written by the text co-authors and reflect their analysis and insight into how to best teach each case.

TestB ank

There is a test bank prepared by the co-authors that contains over 500 multiple choice questions and short-answer/essay questions. It has been tagged with learning objectives, level of difficulty, Bloom's Taxonomy, and AACSB criteria. The AACSB tags allow instructors to sort questions by the various standards and create reports that provide evidence the curriculum satisfies accreditation standards.

PowerPointS lides

To facilitate delivery and preparation of your lectures and to serve as chapter outlines, you'll have access to the PowerPoint presentations that the authors have developed for their own classes. The collection includes approximately 250 professional-looking slides displaying core concepts, analytical procedures, key points, and all the figures in the text chapters.

Accompanying Chapter and Case Videos

A collection of video interviews with executives at such companies as Textron, Verizon, Rio Tinto, and the Coca-Cola Company provide further illustrations of concepts presented in each of the 10 chapters. The importance of ethical and socially responsible business strategies is discussed in an interview with London Business School Professor Lynda Gratton. Five of the cases (Competition in the Movie Rental Industry in 2008, Dell, Inc. in 2008, Google's Strategy in 2009, Walmart Stores, Inc. in 2008, and Southwest Airlines in 2008) have accompanying video segments that can be shown in conjunction with the case discussions. Suggestions for using each video are contained in the teaching notes for that case.

Instructor'sR esourceC D-ROM

All instructor supplements are available to text adopters in this one-stop multimedia resource, including the Instructor's Manual, EZ Test software, PowerPoint presentations, and case videos.

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Karen J. Smith, *Columbia Southern University*
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Troy V. Sullivan, *Middle Georgia College*
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LoriT isher, *University of Missouri*

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BethW oodard, *Belmont University*

As always, we value your recommendations and thoughts about the book. Your comments regarding coverage and content will be taken to heart, and we always are grateful for the time you take to call our attention to printing errors, deficiencies, and other shortcomings. Please e-mail us at **jgamble@usouthal.edu** or **athompso@cba.ua.edu;** fax us at (251) 460-6529; or write us at 104 Mitchell College of Business, The University of South Alabama, Mobile, Alabama 36688.

John E. Gamble

Arthur A. Thompson, Jr.

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Chapter 1

Strategy and the Quest for Competitive Advantage

Chapter Learning Objectives

LO1. Understand the need for having a sound business strategy to successfully compete in the industry, manage the functional areas of the business, and develop new capabilities and assemble resources to strengthen the company's prospects for long-term success.

LO2. Develop an awareness of the four most frequently used and dependable strategic approaches for setting a company apart from rivals and winning a sustainable competitive advantage.

LO3. Understand why a company's strategy tends to evolve over time because of changing circumstances and ongoing management efforts to improve the company's strategy.

LO4. Learn why it is important for a company to have a viable business model that outlines the company's customer value proposition, its profit formula, and the key resources and processes required to create and deliver customer value.

LO5. Learn the three tests that distinguish a winning strategy from a so-so or flawed strategy.

The Importance of Managing Strategically

Three questions must be answered by managers of all types of organizations—small family-owned businesses, rapidly growing entrepreneurial firms, not-for-profit organizations, and the world's leading multinational corporations. These three critical questions are:

- *Where are we now?*
- *Where do we want to go?*
- *How are we going to get there?*

"Where are we now?" is answered by examining the company's current financial performance and market standing, its competitively valuable resources and capabilities, its competitive weaknesses, and changing industry conditions that might affect the company. The answer to the question *"Where do we want to go?"* lies within management's vision of the company's future direction—what new or different customer groups and customer needs it should endeavor to satisfy and how it should change its business makeup. The question *"How are we going to get there?"* challenges managers to craft and execute a strategy capable of moving the company in the intended direction.

A company's **strategy** consists of the competitive moves and business approaches management has developed to attract and please customers, conduct operations, grow the business, and achieve performance objectives.

Developing clear answers to the question *"How are we going to get there?"* is the essence of managing strategically. Rather than relying on the status quo as a roadmap and dealing with new opportunities or threats as they emerge, managing strategically involves developing a business game plan. Management's game plan spells out the competitive moves and business approaches that managers are employing to grow the business, attract and please customers, compete successfully, conduct operations, and achieve targeted levels of performance. Thus, a company's strategy is all about *how: how* to outcompete rivals, *how* to respond to changing economic and market conditions, *how* to manage each functional piece of the business, *how* to develop important resources and capabilities, *how* to take advantage of growth opportunities, and *how* to achieve strategic and financial objectives.

In this opening chapter, we define the concepts of strategy and competitive advantage. The chapter will explain what makes up a company's strategy, explain why strategies are partly proactive and partly reactive, and discuss the relationship between a company's strategy and its business model. The chapter will also introduce you to the kinds of competitive strategies that can give a company an advantage over rivals in attracting customers and earning above-average profits. The chapter concludes by discussing three tests of a winning strategy. While there is no one surefire winning strategy that will always work for every organization in every situation, all top-notch strategies are well-matched to a company's external and internal situation, help build a competitive advantage over rivals, and produce good financial performance. By the end of this chapter, you will have a pretty clear idea of why managing strategically is always the beginning point in the quest for competitive advantage.

The Scope of a Company's Business Strategy

The specific elements that comprise management's answer to the question *"How are we going to get there?"* define a company's business strategy. The company's business strategy lays out how management intends to compete in the industry, manage the functional areas of the business, and develop new capabilities and assemble resources to strengthen the company's prospects for long-term success. There's virtually no area of a company's operations that isn't involved in its business strategy and helps answer the question, *"How are we going to get there?"* Management must have deliberate plans for addressing such issues as:

- Changing economic and market conditions.
- Features and attributes to be included in the company's products or services.
- Pricing of the company's products or services.
- Distribution channels selected for the company's products.
- Reactions to offensive moves by rival sellers.
- Allocation of the company's financial resources.
- Acquisition of new physical assets and resources.
- Development of internal capabilities, competencies, and competitively valuable resources.
- Development of alliances and joint ventures to supplement the company's resources and capabilities.

Of course, business strategy includes planning for topics not included in the list above. The important thing to recognize is that every activity involved in delivering a business's product or service should be guided by strategic thinking. There's really no single activity, process, department, or functional area that should be left to chance. Figure 1.1 presents a diagram showing actions and approaches that make up a company's business strategy. Concepts & Connections 1.1 describes the various elements of McDonald's strategy in the quick service restaurant industry. The capsule should make it clear how the business strategy includes actions related to such wide-ranging issues as its menu selection, supplier relationships, advertising expenditures, expansion into foreign markets, restaurant operating policies and practices, and responses to changing economic and market conditions.

Competitive Strategy and Advantage over Rivals

The most important aspect of a company's business strategy is its approach to competing in the marketplace. It is imperative that a company's strategy strengthen its long-term competitive position and allow it to gain a durable competitive edge over rivals. In Concepts & Connections 1.1, it's evident that McDonald's has gained a competitive advantage over rivals through its efforts to minimize costs, ensure a high level of food quality, add innovative new menu items, and keep its prices low. A creative, distinctive strategy such as

FIGURE 1.1 **Elements of a Company's Business Strategy**

that used by McDonald's is a company's most reliable ticket for developing a sustainable competitive advantage and earning above-average profits. A **sustainable competitive advantage** allows a company to attract sufficiently large numbers of buyers who have a lasting preference for its products or services over those offered by rivals. This enduring demand for a company's products or services is the key to a company's ability to earn ongoing above-average profits.

> A company achieves **sustainable competitive advantage** when an attractively large number of buyers develop a long-lasting preference for its products or services over the offerings of competitors.

Four of the most frequently used and dependable strategic approaches to setting a company apart from rivals and winning a sustainable competitive advantage are:

1. ***Developing a cost-based advantage.*** Wal-Mart and Southwest Airlines have utilized low-cost provider strategies to earn strong market positions in their respective industries. Achieving a cost-based advantage over rivals can produce a durable competitive edge when rivals find it hard to match the low-cost leader's approach to driving costs out of the business. While United Airlines, Delta Airlines, US Airways, and Northwest Airlines have moved in and out of bankruptcy, Southwest Airlines' proficient execution of its low-cost strategy keyed to point-to-point routes, no-frills service, and efficient ground operations has yielded profits for 35 consecutivey ears.
2. ***Creating a differentiation-based advantage.*** A differentiation-based advantage entails adding product or service attributes that offer customers greater tangible or intangible benefits than the product or service

Concepts & Connections 1.1

MCDONALD'S STRATEGY IN THE QUICK-SERVICE RESTAURANT INDUSTRY

In 2009, McDonald's was setting new sales records despite a global economic slowdown and declining consumer confidence in the United States. More than 58 million customers visited one of McDonald's 32,000 restaurants in 118 countries each day, which allowed the company to record 2008 revenues and earnings of more than $23.5 billion and $4.3 billion, respectively. McDonald's performance in the marketplace made it one of only two companies listed on the Dow Jones Industrial Average (the other was Walmart Stores, Inc.) to end 2008 with an increase in the price of its common shares. The company's sales were holding up well amid the ongoing economic uncertainty in early 2009, with systemwide sales as measured in constant currencies increasing by more than 6 percent during January and February. The company's success was a result of its well-conceived and executed Plan to Win business strategy that focused on "being better, not just bigger." Key initiatives of the Plan to Win strategy included:

- **Improved restaurant operations.** McDonald's global restaurant operations improvement process involved employee training programs ranging from on-the-job training for new crew members to college-level management courses offered at the company's Hamburger University. The company also sent nearly 200 high potential employees annually to its McDonald's Leadership Institute to build the leadership skills needed by its next generation of senior managers. McDonald's commitment to employee development earned the company a place on *Fortune*'s list of Top 20 Global Companies for Leaders in 2007. The company also trained its store managers to closely monitor labor, food, and utility costs.
- **Affordable pricing.** In addition to tackling operating costs in each of its restaurants, McDonald's kept its prices low by closely scrutinizing administrative costs and other corporate expenses. McDonald's saw the poor economy in the United States as opportunity to renegotiate its advertising contracts with newspapers and television networks in early 2009. The company also began to replace its company-owned vehicles with more fuel-efficient models when gasoline prices escalated dramatically in the United States during 2008. However, McDonald's did not choose to sacrifice product quality in order to offer lower prices. The company implemented extensive supplier monitoring programs to ensure that its suppliers did not change product specifications to lower costs. For example, the company's chicken breasts were routinely checked for weight when arriving from suppliers' production facilities. The company's broad approach to minimizing non-value-adding expenses allowed it to offer more items on its Dollar Menu in the United States, its Ein Mal Eins menu in Germany, the 100 Yen menu in Japan.
- **Wide menu variety and beverage choices.** McDonald's has expanded its menu beyond the popular-selling Big Mac and Quarter Pounder to include such new healthy quick service items as grilled chicken salads, chicken snack wraps, and premium chicken sandwiches in the United States, Lemon Shrimp Burgers in Germany, and Ebi shrimp wraps in Japan. The company has also added an extensive line of premium coffees that included espressos, cappuccinos, and lattes sold in its McCafe restaurant locations in the United States, Europe, and Asia/Pacific. McDonald's latte was judged "as good or better" than lattes sold by Starbucks or Dunkin Donuts in a review by the *Chicago Tribune*'s Good Eating and Dining staff in December 2008.
- **Convenience and expansion of dining opportunities.** The addition of McCafes helped McDonald's increase same store sales by extending traditional dining hours. Customers wanting a mid-morning coffee or an afternoon snack helped keep store traffic high after McDonald's had sold it last Egg McMuffin, McGriddle, or chicken biscuit and before the lunch crowd arrived to order Big Macs, Quarter Pounders, chicken sandwiches, or salads. The company also extended its drive-thru hours to 24 hours in more than 25,000 locations in cities around the world where consumers tended to eat at all hours of the day. The company also added double drive-thru lanes in the United States to get customers served quickly in high traffic locations.
- **Ongoing restaurant reinvestment.** With more than 14,000 restaurants in the United States, the focus of McDonald's expansion of units was in rapidly growing emerging markets such as Russia and China. The company opened 125 new restaurants in China and 40 new restaurants in Russia in 2008. The company also refurbished about 10,000 of its locations in the United States between 2004 and 2008 as a part of its McCafe rollout and to make its restaurants a pleasant place for both customers to dine and employees to work.

Sources: Janet Adamy, "McDonald's Seeks Way to Keep Sizzling," *The Wall Street Journal Online,* March 10, 2009; various annual reports; various company press releases.

offerings of low-cost rivals. Successful adopters of differentiation strategies include Johnson & Johnson in baby products (product reliability), Harley-Davidson (outlaw image and distinctive sound), Chanel and Rolex (luxury and prestige), Porsche and BMW (engineering design and performance), and Amazon.com (wide selection and convenience). Companies pursuing differentiation strategies must continually seek new innovations, undertake continuing efforts to add to the prestige of a brand, or strive for higher levels of value-adding services to defend against rivals' attempts to imitate the features of a successful differentiator's product offering.

3. ***Focusing on a narrow market niche within an industry.*** Many companies have developed a competitive advantage not only through a strategy keyed to either low costs or differentiation, but also by serving the special needs and tastes of only a small segment of an industry's buyers rather than attempting to appeal to all buyers in an industry. Prominent companies that enjoy competitive success in a specialized market niche include Google in search-based Internet advertising, eBay in online auctions, Best Buy in home electronics, McAfee in virus protection software, and The Weather Channel in cable TV.

4. ***Developing competitively valuable resources and capabilities that rivals can't easily match, copy, or trump with substitute resources.*** Resource-based strategies may be used in tandem with any of the three strategic approaches listed above and are keyed to delivering customer value in ways rivals are unable to match. FedEx has developed a resource-based competitive advantage through its superior distribution capabilities that allow it to promise next-day delivery of small packages within the United States. Over the years, Toyota has developed a sophisticated production system that allows it to produce reliable, largely defect-free vehicles at low cost. Ritz Carlton and Four Seasons have uniquely strong capabilities in providing their hotel guests with highly personalized services. Very often, winning a durable competitive edge over rivals hinges more on building competitively valuable resources and capabilities than it does on having a distinctive product. Clever rivals can nearly always copy the features of a popular product, but it's much more difficult for rivals to match experience, know-how, or specialized resources that a company has developed and perfected over a long period of time.

Why a Company's Strategy Evolves over Time

The appeal of a strategy that yields a sustainable competitive advantage is that it offers the potential for an enduring edge over rivals. However, managers of every company must be willing and ready to modify the strategy in response to the unexpected moves of competitors, shifting buyer needs and preferences, emerging market opportunities, new ideas for improving the strategy, and mounting evidence that the strategy is not working well. Managers should avoid dramatic departures from a proven competitive strategy if at all possible, but it should be expected that the strategy will be fine-tuned and

Changing circumstances and ongoing management efforts to improve the strategy cause a company's strategy to evolve over time—a condition that makes the task of crafting a strategy a work in progress, not a one-time event.

tweaked on a regular basis. Therefore, ***a company's strategy is not a one-time event, but is always a work in progress.***

Even though it's expected that a company's strategy will evolve incrementally, on occasion, major strategy shifts are called for, such as when a strategy is clearly failing and the company faces a financial crisis. In some industries, conditions change at a fairly slow pace, making it feasible for a strategy to remain in place for many years. But in industries where industry and competitive conditions change frequently and in sometimes dramatic ways, the life cycle of a given strategy is short. Industry environments characterized by *high-velocity change* require companies to repeatedly adapt their strategies.[1] For example, companies in industries with rapid-fire advances in technology like medical equipment, electronics, and wireless devices often find it essential to adjust key elements of their strategies several times a year.

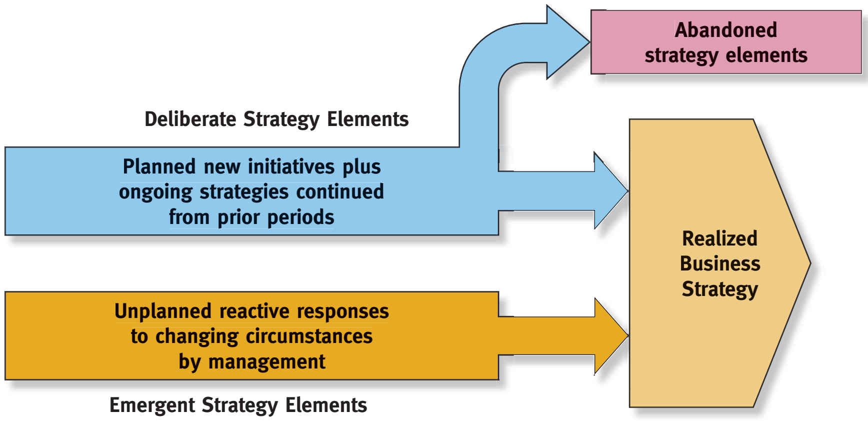
Regardless of whether a company's strategy changes gradually or swiftly, the important point is that a company's present strategy is always fluid. The evolving nature of a company's strategy means that the typical company strategy is a blend of (1) proactive moves to improve the company's financial performance and secure a competitive edge and (2) as-needed responses to unanticipated developments and fresh market conditions—see Figure 1.2.[2] The biggest portion of a company's current strategy flows from ongoing actions that have proven themselves in the marketplace and newly launched initiatives aimed at building a larger lead over rivals and further boosting financial performance. This part of management's action plan for running the company is its proactive, **deliberates trategy.**

At times, components of a company's deliberate strategy will fail in the marketplace and become **abandoned strategy elements.** Although strategy flows from an analysis of the industry and the company's internal capabilities, planned strategies don't always play out as expected. In these cases, it makes much more sense to abandon a losing plan than to blindly adhere to strategy elements destined to fail. Although most elements of the company's deliberate strategy should be expected to survive, some portion of the realized strategy will result from unplanned reactions to unanticipated developments. It should be assumed that there will be occasions when market and competitive conditions take unexpected turns that call for some kind of strategic reaction. Novel strategic moves on the part of rival firms, unexpected shifts in customer preferences, fast-changing technological developments, and

[1] For an excellent treatment of the strategic challenges posed by high velocity changes, see Shona L. Brown and Kathleen M. Eisenhardt, *Competing on the Edge: Strategy as Structured Chaos* (Boston, MA: Harvard Business School Press, 1998), Chapter 1.

[2] See Henry Mintzberg and Joseph Lampel, "Reflecting on the Strategy Process, *Sloan Management Review* 40, no. 3 (Spring 1999), pp. 21–30; Henry Mintzberg and J. A. Waters, "Of Strategies, Deliberate and Emergent," *Strategic Management Journal* 6 (1985), pp. 257–272; Costas Markides, "Strategy as Balance: From 'Either-Or' to 'And,'" *Business Strategy Review* 12, no. 3 (September 2001), pp. 1–10; Henry Mintzberg, Bruce Ahlstrand, and Joseph Lampel, *Strategy Safari: A Guided Tour through the Wilds of Strategic Management* (New York: Free Press, 1998), Chapters 2, 5, and 7; and C. K. Prahalad and Gary Hamel, "The Core Competence of the Corporation," *Harvard Business Review* 70, no. 3 (May–June 1990), pp. 79–93.

FIGURE 1.2 **A Company's Strategy Is A Blend Of Planned Initiatives And Unplanned Reactive Adjustments**



new market opportunities call for unplanned, reactive adjustments that form the company's **emergent strategy.** As shown in Figure 1.2, a company's **realized strategy** tends to be a *combination* of deliberate planned elements and unplanned, emergent elements.

The Importance of a Company's Business Model—Is the Strategy a Money-Maker?

Closely related to the concept of strategy is the concept of a company's **business model.** A company's business model is management's blueprint for delivering a valuable product or service to customers in a manner that will generate revenues sufficient to cover costs and yield an attractive profit. The three elements of a company's business model are (1) its customer value proposition (its approach to satisfying buyer wants and needs at a price customers will consider a good value), (2) the profit formula (determining a cost structure that will allow for acceptable profits given the pricing tied to its customer value proposition), and (3) identification of the key resources and processes that are necessary to create and deliver value to customers.[3]

Ac ompany's **business model** (1) specifies a customer value proposition, (2) develops a profit formula, and (3) identifies key resources and processes required to create and deliver customer value. Absent a tight fit with organizational capabilities and the ability to deliver good profitability, the business model is not viable and the company's ability to survive is in question.

Mobile phone providers, satellite radio companies, and broadband providers employ a subscription-based business model. The business model of network TV and radio broadcasters entails providing free programming to audiences but charging advertising fees based on audience size. Gillette's business model in razor blades involves achieving economies of scale in the production of its shaving products, selling razors at an attractively low price, and then making money on repeat purchases of razor blades. Printer manufacturers like

[3] Mark W. Johnson, Clayton M. Christensen, and Henning Kagermann, "Reinventing Your Business Model," *Harvard Business Review* 86, no. 12 (December 2008), pp. 52–53 and Joan Magretta, "Why Business Models Matter," *Harvard Business Review* 80, no. 5 (May 2002), p. 87.

Hewlett-Packard, Lexmark, and Epson pursue much the same business model as Gillette—achieving economies of scale in production and selling printers at a low (virtually break-even) price and making large profit margins on the repeat purchases of printer supplies, especially ink cartridges.

The nitty-gritty issue surrounding a company's business model is whether it can execute its customer value proposition profitably. Just because company managers have crafted a strategy for competing and running the business does not automatically mean that the strategy will lead to profitability—it may or it may not. The relevance of a company's business model is to clarify (1) *how the business will provide customers with value*, (2) *generate revenues sufficient to cover costs and produce attractive profits*, and (3) *identify whatever resources and processes are critical to the customer value proposition.*

Concepts & Connections 1.2 discusses the contrasting business models of Sirius XM and over-the-air broadcast radio stations.

The Three Tests of a Winning Strategy

Three questions can be used to distinguish a winning strategy from a so-so or flawed strategy:

1. ***Does the strategy fit the company's situation?*** To qualify as a winner, a strategy has to be well matched to the company's external and internal situations. The strategy must fit competitive conditions in the industry and other aspects of the enterprise's external environment. At the same time, it should be tailored to the company's collection of competitively important resources and capabilities. It's unwise to build a strategy upon the company's weaknesses or pursue a strategic approach that requires resources that are deficient in the company. Unless a strategy exhibits tight fit with both the external and internal aspects of a company's overall situation, it is unlikely to produce respectable first-rate business results.

A winning strategy must fit the company's external and internal situation, yield a sustainable competitive advantage, and produce good financial performance.

2. ***Has the strategy yielded a sustainable competitive advantage?*** Strategies that fail to achieve a durable competitive advantage over rivals are unlikely to produce superior performance for more than a brief period of time. Winning strategies enable a company to achieve a competitive advantage over key rivals that is long lasting.
3. ***Has the strategy produced good financial performance?*** It would be difficult to categorize a strategy as a "winning strategy" unless it produces excellent company performance. Two kinds of performance improvements tell the most about the caliber of a company's strategy: (1) gains in profitability and financial strength and (2) advances in the company's competitive strength and market standing.

Strategies that come up short on one or more of the above tests are plainly less appealing than strategies passing all three tests with flying colors.

Concepts & Connections 1.2

SIRIUS XM AND OVER-THE-AIR BROADCAST RADIO: TWO CONTRASTING BUSINESS MODELS

The strategies of rival companies are often predicated on strikingly different business models. Consider, for example, the business models for over-the-air radio broadcasters and Sirius XM.

The business model of over-the-air broadcast radio—providing listeners with programming free-of-charge and charging advertisers fees—is a proven money-maker. On the other hand, the jury is still out on Sirius XM's business model of charging subscription fees to listeners who prefer rarely interrupted digital music, news, or talk radio programming. As of year-end 2008, Sirius XM's number of subscribers had grown to 19 million and its annual revenues had reached to nearly $2.4 billion, but it had had yet to earn a profit.

	Sirius XM	Over-the-Air Radio Broadcasters
Customer Value Proposition	Digital music, news, national and regional weather, traffic reports in limited areas, and talk radio programming provided for a monthly subscription fee. Programming was interrupted only by brief, occasional ads.	Free-of-charge music, national and local news, local traffic reports, national and local weather, and talk radio programming. Listeners could expect frequent programming interruption for ads.
Profit Formula	***Revenue Generation:*** Monthly subscription fees. sales of satellite radio equipment, and advertising revenues ***Cost Structure:*** Fixed costs associated with operating a satellite-based music delivery service. Fixed and variable costs related to programming and content royalties, marketing, and support activities. ***Profit Margin:*** Sirius XM's profitability was dependent on attracting a sufficiently large number of subscribers to cover its costs and provide for attractive profits.	***Revenue Generation:*** Advertising sales to national and local businesses. ***Cost Structure:*** Fixed costs associated with terrestrial broadcasting operations. Fixed and variable costs related to local news reporting, advertising sales operations, network affiliate fees, programming and content royalties, commercial production activities, and support activities. ***Profit Margin:*** The profitability of over-the-air radio stations was dependent on generating sufficient advertising revenues to cover costs and provide for attractive profits.
Key Resources and Processes	Property and equipment, satellite transmission capabilities, terrestrial repeaters, digital audio radio service license from FCC, programming contracts, alliances with electronics manufacturers, alliances with automobile manufacturers, sales and distribution agreements with electronics retailers, brand building and marketing capabilities.	Radio broadcast towers and other facilities, sales personnel, expertise in developing programming to increase audience size and independent ratings, information systems capable of optimizing commercial pricing and inventory, FCC license, programming contracts.

Source: Company documents, 10-Ks, and information posted on their Web sites.

Managers should use the same questions when evaluating either proposed or existing strategies. New initiatives that don't seem to match the company's internal and external situation should be scrapped before they come to fruition, while existing strategies must be scrutinized on a regular basis to ensure they have good fit, offer a competitive advantage, and have contributed to above-average performance.

The Road Ahead

Throughout the chapters to come and the accompanying case collection, the spotlight is trained on the foremost question in running a business enterprise: *What must managers do, and do well, to make a company a winner in the marketplace?* The answer that emerges is that doing a good job of managing inherently requires good strategic thinking and good management of the strategy-making, strategy-executing process.

The mission of this book is to provide a solid overview of what every business student and aspiring manager needs to know about crafting and executing strategy. We will explore what good strategic thinking entails, describe the core concepts and tools of strategic analysis, and examine the ins and outs of crafting and executing strategy. The accompanying cases will help build your skills in both diagnosing how well the strategy-making, strategy-executing task is being performed and proposing recommendations to improve the strategic and financial performance of the company profiled in a case. The strategic management course that you are enrolled in may also include a strategy simulation exercise where you will run a company in head-to-head competition with companies run by your classmates. Your mastery of the strategic management concepts presented in the following chapters will put you in a strong position to craft a winning strategy for your company and figure out how to execute it in a cost-effective and profitable manner. As you progress through the chapters of the text and the activities assigned during the term, we hope to convince you that first-rate capabilities in crafting and executing strategy are essential to good management.

KeyP oints

1. A company's strategy is management's game plan to stake out a market position, conduct its operations, attract and please customers, compete successfully, and achieve organizational objectives.
2. The central thrust of a company's strategy is undertaking moves to build and strengthen the company's long-term competitive position and financial performance. Ideally, this results in a competitive advantage over rivals that then becomes the company's ticket to above-average profitability.

3. A company's strategy typically evolves over time, arising from a blend of (1) proactive and deliberate actions on the part of company managers and (2) as-needed emergent responses to unanticipated developments and fresh market conditions.
4. Closely related to the concept of strategy is the concept of a company's business model. A company's business model (1) specifies a customer value proposition, (2) develops a profit formula, and (3) identifies key resources and processes required to create and deliver customer value. Absent a tight fit with organizational capabilities and the ability to deliver good profitability, the business model is not viable and the company's ability to survive is in question.
5. Aw innings trategyfi ts the circumstances of a company's external situation and its internal resource strengths and competitive capabilities, builds competitive advantage, and boosts company performance.

Assurance of Learning Exercises

1. Got o www.bestbuy.com, click on the investor relations section and explore Best Buy's latest annual reports and 10-K filings to see if you can identify the key elements of Best Buy's strategy. Use the framework provided in Figure 1.1 to help identify the key elements of Best Buy's strategy. What type of competitive advantage does Best Buy seem to be pursuing? **LO1 LO2**
2. Based on what you know about the quick-service restaurant industry, does McDonald's strategy as described in Concepts & Connections 1.1 seem to be well-matched to industry and competitive conditions? Does the strategy seem to be keyed to a cost-based advantage, differentiating features, serving the unique needs of a niche, or developing resource strengths and competitive capabilities rivals can't imitate or trump (or a mixture of these)? What is there about McDonald's strategy that can lead to sustainable competitive advantage? **LO1 LO2**
3. Got o www.nytco.com/investors and check whether the *New York Times*'r ecent financial reports indicate that its business model is working. Does the company's business model remain sound as more consumers go to the Internet to find general information and stay abreast of current events and news stories? Is its revenue stream from advertisements growing or declining? Are its subscription fees and circulation increasing or declining? Read the company's latest press releases. Is there evidence that the company's business model is evolving? Does the company possess the necessary key resources and process capabilities to support a change in its business model? **LO4**

Exercisesf or Simulation Participants

This chapter discusses three questions that must be answered by managers of organizations of all sizes. After you have read the player's manual for the strategy simulation exercise that you will participate in during this academic term, you and your co-managers should come up with brief 1- or 2-paragraph answers to the following three questions prior to entering your first set of decisions. While your answers to the first of the three questions can be developed from your reading of the manual, the second and third questions will require a collaborative discussion among the members of your company's management team about how you intend to manage the company you have been assigned to run. **LO1**

1. Where are we now? (Is your company in a good, average, or weak competitive position vis-à-vis rival companies? Does your company appear to be in sound financial condition? What problems does your company have that need to be addressed?)
2. Where do we want to go? (Where would you like your company to be after the first five decision rounds? By how much would you like to increase total profits of the company by the end of the simulation exercise? What kinds of performance outcomes will signal that you and your co-managers are managing the company in a successful manner?)
3. How are we going to get there? (Which of the basic strategic and competitive approaches discussed in Chapter 1 do you think makes the most sense to pursue? What kind of competitive advantage over rivals do you intend to try to build?)

Chapter 2

Leadership and the Strategic Management Process

Chapter Learning Objectives

LO1. Grasp why it is critical for company managers to have a clear strategic vision of where a company needs to head and why.

LO2. Understand the importance of setting both financial and strategic objectives and using a Balanced Scorecard to track performance.

LO3. Understand why the strategic initiatives taken at various organizational levels must be tightly coordinated to achieve companywide performance targets.

LO4. Become aware of what a company must do to achieve operating excellence and to execute its strategy proficiently.

LO5. Learn what leadership skills management must exhibit to drive strategy execution forward.

LO6. Understand why the strategic management process is an ongoing process.

LO7. Become aware of the role and responsibility of a company's board of directors in overseeing the strategic management process.

Crafting and executing strategy are the heart and soul of managing a business enterprise. But exactly what is involved in developing a strategy and executing it proficiently? What are the various components of the strategy-making, strategy-executing process and to what extent are company personnel—aside from senior management—involved in the process? In this chapter we present an overview of the ins and outs of crafting and executing company strategies. Special attention will be given to management's direction-setting responsibilities—charting a strategic course, setting performance targets, and choosing a strategy capable of producing the desired outcomes. We will also explain why strategy making is a task for a company's entire management team and discuss which kinds of strategic decisions tend to be made at which levels of management. The chapter concludes with a look at strategic leadership by a company's board of directors and how good corporate governance protects shareholder interests and promotes good management.

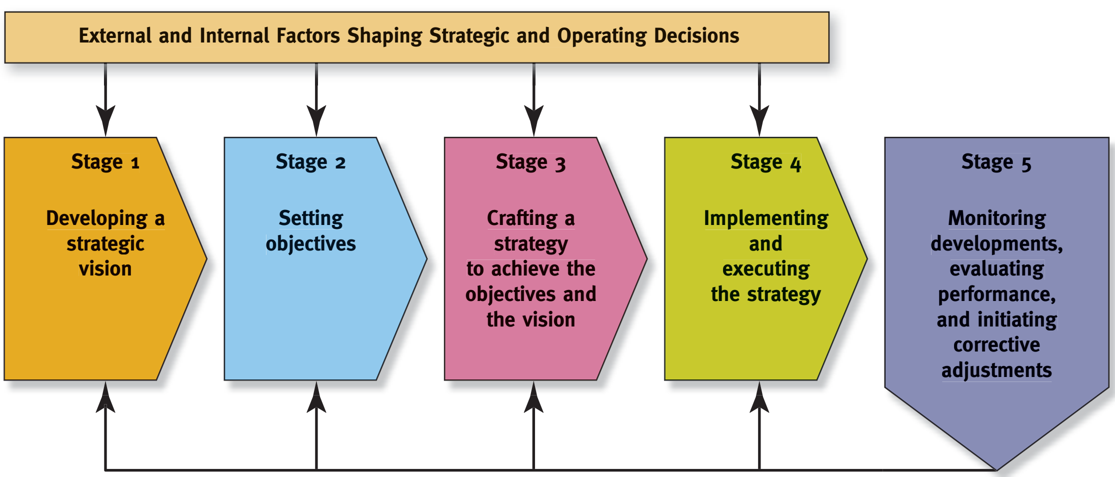
The Strategic Management Process

The managerial process of crafting and executing a company's strategy consists of five integrated stages:

1. ***Developing a strategic vision*** of the company's future direction and focus.
2. ***Setting objectives*** to measure progress toward achieving the strategic vision.
3. ***Crafting a strategy*** to achieve the objectives.
4. ***Implementing and executing the chosen strategy*** efficiently and effectively.
5. ***Evaluating performance and initiating corrective adjustments*** that are needed in the company's long-term direction, objectives, strategy, or approach to strategy execution.

Figure2.1 displays this five-stage process. The model illustrates the need for management to evaluate a number of external and internal factors in deciding

FIGURE 2.1 **The Strategic Management Process**



upon a strategic direction, appropriate objectives, and approaches to crafting and executing strategy—see Table 2.1. Management's decisions that are made in the strategic management process must be shaped by the prevailing economic conditions and competitive environment and the company's own internal resources and competitive capabilities. These strategy shaping conditions will be the focus of Chapters 3 and 4.

Table2.1

Factors Shaping Decisions in the Strategic Management Process

EXTERNAL CONSIDERATIONS	INTERNAL CONSIDERATIONS
What are the industry's dominant economic characteristics? Industry features such as market size and growth rate, the number and relative sizes of buyers and sellers, the speed of product innovation, the pace of technological change, the importance of scale economies, and the geographic scope of competitive rivalry have significant bearing on management's decisions regarding the vision, strategic and financial objectives, and business strategy.	**How well is the present strategy working?** The stronger a company's current overall performance, the less likely the need for radical strategy changes. The weaker a company's performance, the more its current vision, strategy, and approach to strategy execution must be questioned.
What kind of competitive forces are industry members facing, and how strong is each force? A company's strategy must shield it from as many of the prevailing competitive pressures as possible and attempt to shift competition in the company's favor.	**What are the company's competitively valuable resources, capabilities, and internal weaknesses?** A company's strengths are strategically relevant because they are the logical building blocks for its strategy and approach to executing the strategy; internal weaknesses are important for strategy makers and strategy executers to consider because they may represent vulnerabilities that need correction.
What forces are driving change in the industry? In deciding upon strategic choices and appropriate objectives, managers must consider if the industry driving forces are causing demand to increase or decrease, make competition more or less intense, and lead to higher or lower industry profitability.	**Are the company's prices and costs competitive?** Managers charged with strategy making or strategy execution must determine whether the company is performing internal functions and activities in a cost-effective manner and if the company's costs are in line with those of competitors.
What market positions do industry rivals occupy and what strategic moves are rivals likely to make next? Industry driving forces and competitive forces favor some strategic groups and hurt others. Also, managers who fail to study competitors risk being caught unprepared by the strategic moves of rivals.	**Is the company competitively stronger or weaker than key rivals?** Management should build the company's strategy and approach to executing the strategy around its competitive strengths and should improve areas where the company is vulnerable to best defend or enhance its market position.
What are the key factors for future competitive success? All industries are characterized by a set of strategy elements, competitive capabilities, or product attributes that all companies must master to be successful. Managers should make the industry's key success factors cornerstones of its strategy and standout internal competitive capabilities.	
What are the company's external opportunities and threats? Management's strategy should attempt to capture the company's most attractive opportunities and defend against threats to its well-being.	

The model shown in Figure 2.1 also illustrates the need for management to evaluate the company's performance on an ongoing basis. Any indication that the company is failing to achieve its objectives calls for corrective adjustments in one of the first four stages of the process. It's quite possible that the company's implementation efforts have fallen short and that new tactics must be devised to fully exploit the potential of the company's strategy. If management determines that the company's execution efforts are sufficient, it should challenge the assumptions underlying the company's business strategy and alter the strategy to better fit competitive conditions and the company's internal capabilities. If the company's strategic approach to competition is rated as sound, then perhaps management set overly ambitious targets for the company's performance.

The evaluation stage of the strategic management process shown in Figure 2.1 also allows for a change in the company's vision, but this should only be necessary when it becomes evident to management that the industry has changed in a significant way that renders its vision obsolete. Such occasions can be referred to as **strategic inflection points.** When a company reaches a strategic inflection point, management has some tough decisions to make about the company's direction, because abandoning an established course carries considerable risk. However, responding to unfolding changes in the marketplace in timely fashion lessens a company's chances of becoming trapped in a stagnant or declining business or letting attractive new growth opportunities slip away.

The first three stages of the strategic management process make up a strategic plan. A **strategic plan** maps out where a company is headed, establishes strategic and financial targets, and outlines the competitive moves and approaches to be used in achieving the desired business results.[1]

Ac ompany's **strategic plan** lays out its future direction, performance targets, and strategy.

Developing a Strategic Vision: Stage 1 of the Strategic Management Process

Top management's views about the company's direction and future product-customer-market-technology focus are shaped by its views of the external industry and competitive environment and internal situation and constitute a **strategic vision** for the company. A clearly articulated strategic vision communicates management's aspirations to stakeholders about "where we are going" and helps steer the energies of company personnel in a common direction. For

A **strategic vision** describes "where we are going"—the course and direction management has charted and the company's future product-customer-market-technology focus.

[1] For an excellent discussion of why a strategic plan needs to be more than a list of bullet points and should in fact tell an engaging, insightful, stage-setting story that lays out the industry and competitive situation as well as the vision, objectives, and strategy, see Gordon Shaw, Robert Brown, and Philip Bromiley, "Strategic Stories: How 3M Is Rewriting Business Planning," *Harvard Business Review* 76, no. 3 (May–June 1998), pp. 41–50. For a valuable discussion of the role of mission, vision, objectives, and strategy statements in providing organizational direction, see David J. Collins and Michael G. Rukstad, "Can You Say What Your Strategy Is?" *Harvard Business Review* 86, no. 4 (April 2008), pp. 82–90.

instance, Henry Ford's vision of a car in every garage had power because it captured the imagination of others, aided internal efforts to mobilize the Ford Motor Company's resources, and served as a reference point for gauging the merits of the company's strategic actions.

Well-conceived visions are *specific* to a particular organization; they avoid generic, feel-good statements like "We will become a global leader and the first choice of customers in every market we choose to serve"—which could apply to any of hundreds of organizations.[2] And they are not the product of a committee charged with coming up with an innocuous but well-meaning one-sentence vision that wins consensus approval from various stakeholders. Nicely worded vision statements with no specifics about the company's product-market-customer-technology focus fall well short of what it takes for a vision to measure up.

For a strategic vision to function as a valuable managerial tool, it must provide understanding of what management wants its business to look like and provide managers with a reference point in making strategic decisions. It must say something definitive about how the company's leaders intend to position the company beyond where it is today. Table 2.2 lists some characteristics of effective vision statements.

A surprising number of the vision statements found on company Web sites and in annual reports are vague and unrevealing, saying very little about the company's future product-market-customer-technology focus.

[2] For a more in-depth discussion of the challenges of developing a well-conceived vision, as well as some good examples, see Hugh Davidson, *The Committed Enterprise: How to Make Vision and Values Work* (Oxford: Butterworth Heinemann, 2002), Chapter 2; W. Chan Kim and Renée Mauborgne, "Charting Your Company's Future," *Harvard Business Review* 80, no. 6 (June 2002), pp. 77–83; James C. Collins and Jerry I. Porras, "Building Your Company's Vision," *Harvard Business Review* 74, no. 5 (September–October 1996), pp. 65–77; Jim Collins and Jerry Porras, *Built to Last: Successful Habits of Visionary Companies* (New York: HarperCollins, 1994), Chapter 11; and Michel Robert, *Strategy Pure and Simple II* (New York: McGraw-Hill, 1998), Chapters 2, 3, and 6.

Table 2.2

Characteristics of Effectively Worded Vision Statements

Graphic—Paints a picture of the kind of company that management is trying to create and the market position(s) the company is striving to stake out.

Directional—Is forward looking; describes the strategic course that management has charted and the kinds of product-market-customer-technology changes that will help the company prepare for the future.

Focused—Is specific enough to provide managers with guidance in making decisions and allocating resources.

Flexible—Is not so focused that it makes it difficult for management to adjust to changing circumstances in markets, customer preferences, or technology.

Feasible—Is within the realm of what the company can reasonably expect to achieve.

Desirable—Indicates why the directional path makes good business sense.

Easy to communicate—Is explainable in 5–10 minutes and, ideally, can be reduced to a simple, memorable "slogan" (like Henry Ford's famous vision of "a car in every garage").

Source: Based partly on John P. Kotter, *Leading Change* (Boston: Harvard Business School Press, 1996), p. 72.

Some could apply to most any company in any industry. Many read like a public relations statement—lofty words that someone came up with because it is fashionable for companies to have an official vision statement.[3] Table 2.3 provides a list of the most common shortcomings in company vision statements. Like any tool, vision statements can be used properly or improperly, either clearly conveying a company's strategic course or not. Concepts & Connections 2.1 provides a critique of the strategic visions of several prominent companies.

How a Strategic Vision Differs from a Mission Statement

The defining characteristic of a well-conceived strategic vision is what it says about the company's *future strategic course*—"*where we are headed and what our future product-customer-market-technology focus will be.*" The mission statements of most companies say much more about the enterprise's *present* business scope and purpose—"who we are, what we do, and why we are here." Very few mission statements are forward looking in content or emphasis. Consider, for example, the mission statement of Trader Joe's (a specialty grocery chain):

> The distinction between a strategic vision and a mission statement is fairly clear-cut: A strategic vision portrays a company's **future business scope** ("where we are going") whereas a company's mission typically describes its **present business and purpose** ("who we are, what we do, and why we are here").

> The mission of Trader Joe's is to give our customers the best food and beverage values that they can find anywhere and to provide them with the information required for informed buying decisions. We provide these with a dedication to the highest quality of customer satisfaction delivered with a sense of warmth, friendliness, fun, individual pride, and company spirit.

[3] Hugh Davidson, *The Committed Enterprise* (Oxford: Butterworth Heinemann, 2002), pp. 20 and 54.

Table 2.3

Common Shortcomings in Company Vision Statements

Vague or incomplete—Short on specifics about where the company is headed or what the company is doing to prepare for the future.

Not forward looking—Doesn't indicate whether or how management intends to alter the company's current product-market-customer-technology focus.

Too broad—So all-inclusive that the company could head in most any direction, pursue most any opportunity, or enter most any business.

Bland or uninspiring—Lacks the power to motivate company personnel or inspire shareholder confidence about the company's direction.

Not distinctive—Provides no unique company identity; could apply to companies in any of several industries (including rivals operating in the same market arena).

Too reliant on superlatives—Doesn't say anything specific about the company's strategic course beyond the pursuit of such distinctions as being a recognized leader, a global or worldwide leader, or the first choice of customers.

Sources: Based on information in Hugh Davidson, *The Committed Enterprise* (Oxford: Butterworth Heinemann, 2002), chapter 2; and Michel Robert, *Strategy Pure and Simple II* (New York: McGraw-Hill, 1998), chapters 2, 3, and 6.

Concepts & Connections 2.1

EXAMPLES OF STRATEGIC VISIONS—HOW WELL DO THEY MEASURE UP?

VISION STATEMENT	EFFECTIVE ELEMENTS	SHORTCOMINGS
Red Hat Linux To extend our position as the most trusted Linux and open source provider to the enterprise. We intend to grow the market for Linux through a complete range of enterprise Red Hat Linux software, a powerful Internet management platform, and associated support and services.	• Directional • Focused • Feasible • Desirable • Easy to communicate	• Bland or uninspiring
UBS We are determined to be the best global financial services company. We focus on wealth and asset management, and on investment banking and securities businesses. We continually earn recognition and trust from clients, shareholders, and staff through our ability to anticipate, learn and shape our future. We share a common ambition to succeed by delivering quality in what we do. Our purpose is to help our clients make financial decisions with confidence. We use our resources to develop effective solutions and services for our clients. We foster a distinctive, meritocratic culture of ambition, performance and learning as this attracts, retains and develops the best talent for our company. By growing both our client and our talent franchises, we add sustainable value for our shareholders.	• Focused • Feasible • Desirable	• Not forward-looking • Bland or uninspiring
Caterpillar Be the global leader in customer value.	• Directional • Desirable • Easy to communicate	• Vague or incomplete • Could apply to many companies in many industries
eBay Provide a global trading platform where practically anyone can trade practically anything.	• Graphic • Flexible • Easy to Communicate	• Too broad

Sources: Company documents and Web sites.

Note that Trader Joe's mission statement does a good job of conveying "who we are, what we do, and why we are here," but it provides no sense of "where we are headed." (Some companies use the term *business purpose* instead of *mission statement* in describing themselves; in actual practice, there seems to be no meaningful difference between the *terms mission statement* and *business purpose*—which one is used is a matter of preference.)

To reflect common management practice, we will use the term *mission statement* to refer to an enterprise's description of its *present* business and its purpose for existence. Ideally, a company mission statement is sufficiently descriptive to:

- *Identify the company's products or services.*
- *Specify the buyer needs it seeks to satisfy.*
- *Specify the customer groups or markets it is endeavoring to serve.*
- *Specifyi tsa pproacht opl easingc ustomers.*

Occasionally, companies state that their mission is to simply earn a profit. This is misguided. Profit is more correctly an *objective* and a *result* of what a company does.

An example of a well-stated mission statement with ample specifics about what the organization does is that of the Occupational Safety and Health Administration (OSHA): "to assure the safety and health of America's workers by setting and enforcing standards; providing training, outreach, and education; establishing partnerships; and encouraging continual improvement in workplace safety and health." Google's mission statement, while short, still captures the essence of what the company is about: "to organize the world's information and make it universally accessible and useful." An example of a not-so-revealing mission statement is that of Microsoft. "To help people and businesses throughout the world realize their full potential" says nothing about its products or business makeup and could apply to many companies in many different industries. A mission statement that provides scant indication of "who we are and what we do" has no apparent value.

The Importance of Communicating the Strategic Vision

A strategic vision has little value to the organization unless it's effectively communicated down the line to lower-level managers and employees. It would be difficult for a vision statement to provide direction to decision makers and energize employees toward achieving long-term strategic intent unless they know of the vision and observe management's commitment to that vision. Communicating the vision to organization members nearly always means putting "where we are going and why" in writing, distributing the statement organizationwide, and having executives personally explain the vision and its rationale to as many people as feasible. Ideally, executives should present their vision for the company in a manner that reaches out and grabs people's attention. An engaging and convincing strategic vision has enormous motivational value—for the same reason that a stone mason is inspired by building a great cathedral for the ages. Therefore, an executive's ability to paint a convincing and inspiring picture of a company's journey to a future destination is an important element of effective strategic leadership.[4]

[4] Ibid., pp. 36, 54.

The Benefits of an Effective Strategic Vision

In sum, a well-conceived, effectively communicated strategic vision pays off in several respects: (1) it crystallizes senior executives' own views about the firm's long-term direction; (2) it reduces the risk of rudderless decision making by management at all levels; (3) it is a tool for winning the support of employees to help make the vision a reality; (4) it provides a beacon for lower-level managers in forming departmental missions; and (5) it helps an organization prepare for the future.

Setting Objectives: Stage 2 of the Strategic Management Process

The managerial purpose of setting **objectives** is to convert the strategic vision into specific performance targets. Objectives reflect management's aspirations for company performance in light of the industry's prevailing economic and competitive conditions and the company's internal capabilities. Well-stated objectives are *quantifiable,* or *measurable,* and contain a *deadline for achievement.* Concrete, measurable objectives are managerially valuable because they serve as yardsticks for tracking a company's performance and progress toward its vision. Vague targets like "maximize profits," "reduce costs," "become more efficient," or "increase sales," which specify neither how much nor when, offer little value as a management tool to improve company performance. Ideally, managers should develop *challenging,* yet *achievable* objectives that *stretch an organization to perform at its full potential.* As Mitchell Leibovitz, former CEO of the auto parts and service retailer Pep Boys, once said, "If you want to have ho-hum results, have ho-hum objectives."

What Kinds of Objectives to Set—The Need for a Balanced Scorecard

Two very distinct types of performance yardsticks are required: those relating to financial performance and those relating to strategic performance. **Financial objectives** communicate management's targets for financial performance. Common financial objectives relate to revenue growth, profitability, and return on investment. **Strategic objectives** are related to a company's marketing standing and competitive vitality. The importance of attaining financial objectives is intuitive. Without adequate profitability and financial strength, a company's long-term health and ultimate survival is jeopardized. Furthermore, subpar earnings and a weak balance sheet alarm shareholders and creditors and put the jobs of senior executives at risk. However, good financial performance, by itself, is not enough.

> *Financial objectives* relate to the financial performance targets management has established for the organization to achieve. *Strategic objectives* relate to target outcomes that indicate a company is strengthening its market standing, competitive vitality, and future businessp rospects.

A company's financial objectives are really *lagging indicators* that reflect the results of past decisions and organizational activities.[5] The results of

[5] Robert S. Kaplan and David P. Norton, *The Strategy-Focused Organization* (Boston: Harvard Business School Press, 2001), p. 3.

past decisions and organizational activities are not reliable indicators of a company's future prospects. Companies that have been poor financial performers are sometimes able to turn things around and good financial performers on occasion fall upon hard times. Hence, the best and most reliable predictors of a company's success in the marketplace and future financial performance are strategic objectives. Strategic outcomes are *leading indicators* of a company's future financial performance and business prospects. The accomplishment of strategic objectives signals the company is well-positioned to sustain or improve its performance. For instance, if a company is achieving ambitious strategic objectives, then there's reason to expect that its *future* financial performance will be better than its current or past performance. If a company begins to lose competitive strength and fails to achieve important strategic objectives, then its ability to maintain its present profitability is highly suspect.

Consequently, utilizing a performance measurement system that strikes a *balance* between financial objectives and strategic objectives is optimal.[6] Just tracking a company's financial performance overlooks the fact that what ultimately enables a company to deliver better financial results is the achievement of strategic objectives that improve its competitiveness and market strength. Representative examples of financial and strategic objectives that companies often include in a balanced scorecard approach to measuring their performance are displayed in Table 2.4.[7]

In 2008, nearly 60 percent of global companies used a balanced scorecard approach to measuring strategic and financial performance.[8] Examples of organizations that have adopted a balanced scorecard approach to setting objectives and measuring performance include UPS, Ann Taylor Stores, UK Ministry of Defense, Caterpillar, Daimler AG, Hilton Hotels, Duke University Hospital, and Siemens AG.[9] Concepts and Connections 2.2 provides selected strategic and financial objectives of four prominent companies.

SHORT-TERM AND LONG-TERM OBJECTIVES A company's set of financial and strategic objectives should include both near-term and long-term performance targets. Short-term objectives focus attention on delivering performance improvements in the current period, while long-term targets force the organization to consider how actions currently under way will

[6] Ibid., p. 7. Also, see Robert S. Kaplan and David P. Norton, *The Balanced Scorecard: Translating Strategy into Action* (Boston: Harvard Business School Press, 1996), p. 10; Kevin B. Hendricks, Larry Menor, and Christine Wiedman, "The Balanced Scorecard: To Adopt or Not to Adopt," *Ivey Business Journal* 69, no. 2 (November–December 2004), pp. 1–7; and Sandy Richardson, "The Key Elements of Balanced Scorecard Success," *Ivey Business Journal* 69, no. 2 (November–December 2004), pp. 7–9.

[7] Kaplan and Norton, *The Balanced Scorecard: Translating Strategy into Action*, pp. 25–29. Kaplan and Norton classify strategic objectives under the categories of customer-related, business processes, and learning and growth. In practice, companies using the Balanced Scorecard may choose categories of strategic objectives that best reflect the organization's value-creating activities and processes.

[8] Information posted on the Web site of Bain and Company, www.bain.com, accessed May 27, 2009.

[9] Information posted on the Web site of Balanced Scorecard Institute, accessed May 27, 2009.

Concepts & Connections 2.2

EXAMPLES OF COMPANY OBJECTIVES

GeneralM otors

Reduce the percentage of automobiles using conventional internal combustion engines (ICE) through the development of hybrid ICEs, plug-in hybrid ICEs, range-extended electric vehicles, and hydrogen fuel cell electric engines; reduce automotive structural costs to benchmark levels of 23 percent of revenue by 2012 from 34 percent in 2005; and reduce annual U.S. labor costs by an additional $5 billion by 2011.

TheH ome Depot

Be the number one destination for professional contractors, whose business accounted for roughly 30 percent of 2006 sales; improve in-stock positions so customers can find and buy exactly what they need; deliver differentiated customer service and the know-how that our customers have come to expect from The Home Depot; repurchase $22.5 billion of outstanding shares during 2008; and open 55 new store locations with 5 store relocations in 2008.

Yum Restaurants (KFC, Pizza Hut, and Taco Bell)

Open 100+ KFC restaurants in Vietnam by 2010; expand Taco Bell restaurant concept to Dubai, India, Spain and Japan during 2008 and 2009; increase number of international restaurant locations from 12,000 in 2007 to 15,000 in 2012; increase operating profit from international operations from $480 million in 2007 to $770 million in 2012; expand Pizza Hut's menu to include pasta and chicken dishes; decrease the number of company owned restaurant units in U.S. from 20% of units in 2007 to less than 10% of units by 2010; and increase the number of Taco Bell units in the U.S. by 2%–3% annually between 2008 and 2010.

Avon

Increase our beauty sales and market share; strengthen our brand image; enhance the representative experience; realize annualized cost savings of $430 million through improvements in marketing processes, sales model and organizational activities; and achieve annualized cost savings of $200 million through a strategic sourcing initiative.

Source: Information posted on company Web sites, accessed March 27, 2008.

affect the company at a later date. Specifically, long-term objectives stand as a barrier to a nearsighted management philosophy and an undue focus on short-term results. When trade-offs have to be made between achieving long-run and short-run objectives, long-run objectives should take precedence (unless the achievement of one or more short-run performance targets has unique importance).

THE NEED FOR OBJECTIVES AT ALL ORGANIZATIONAL LEVELS

Objective setting should not stop with the establishment of companywide performance targets. Company objectives need to be broken down into performance targets for each of the organization's separate businesses, product lines, functional departments, and individual work units. Employees within various functional areas and operating levels will be guided much better by narrow objectives relating directly to their departmental activities than broad

Table2.4

The Balanced Scorecard Approach to Performance Measurement

FINANCIAL OBJECTIVES	STRATEGIC OBJECTIVES	
• An *x* percent increase in annual revenues • Annual increases in earnings per share of *x* percent • An *x* percent return on capital employed (ROCE) or shareholder investment (ROE) • Bond and credit ratings of *x* • Internal cash flows of *x* to fund new capital investment	• Winning an *x* percent market share • Achieving customer satisfaction rates of *x* percent • Achieving a customer retention rate of *x* percent • Acquire *x* number of new customers • Introduction of *x* number of new products in the next three years • Reduce product development times to *x* months	• Increase percentage of sales coming from new products to *x* percent • Improve information systems capabilities to give frontline managers defect information in *x* minutes • Improve teamwork by increasing the number of projects involving more than one business unit to *x*

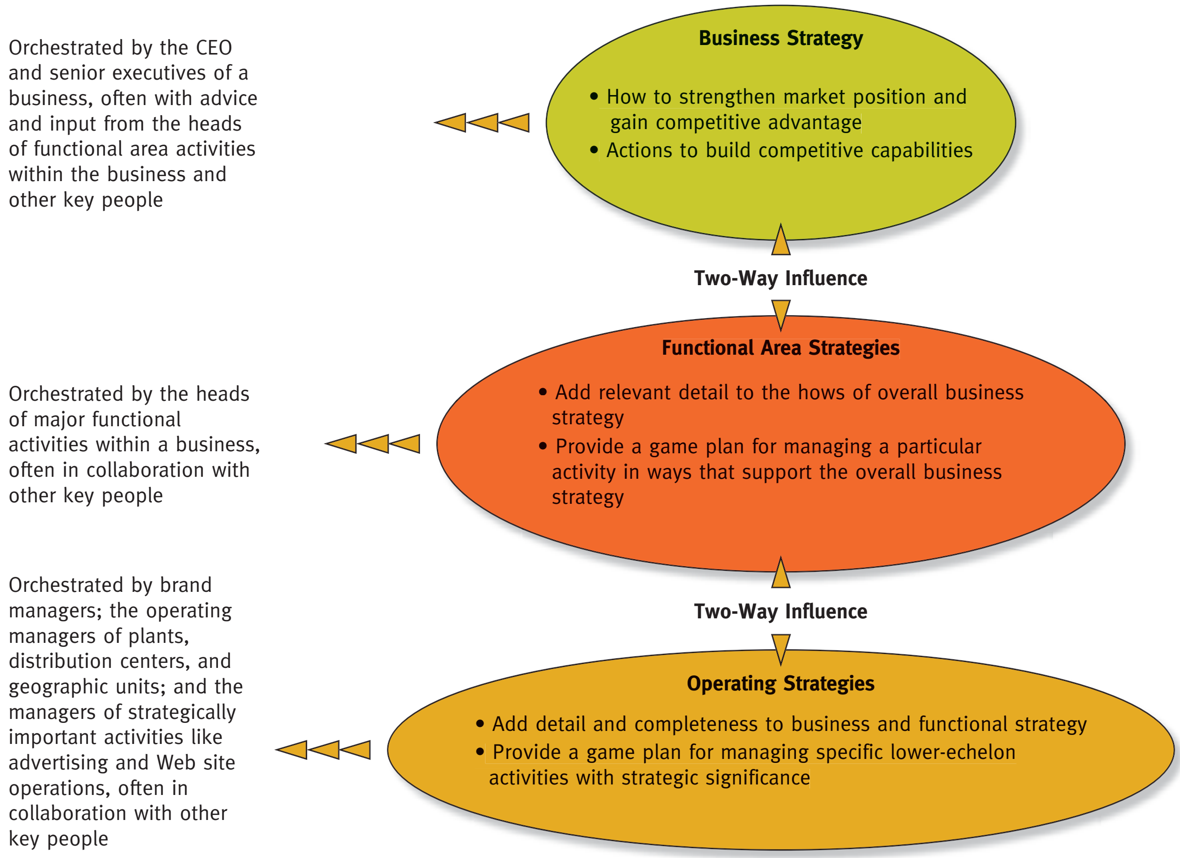
organizational level goals. Objective setting is thus a top-down process that must extend to the lowest organizational levels. And it means that each organizational unit must take care to set performance targets that support—rather than conflict with or negate—the achievement of companywide strategic and financial objectives.

Crafting a Strategy: Stage 3 of the Strategic Management Process

As discussed in Chapter 1, management's strategic approach to achieving organizational objectives, competing successfully, and building competitively important capabilities must be well-matched to the company's external and internal situation. The business strategy elements crafted by management must also be cohesive and mutually reinforcing, fitting together like a jigsaw puzzle. To achieve such unity, top executives must clearly articulate key strategic themes to guide lower-level strategy makers. For example, functional area managers of a company pursuing a cost-based advantage must adopt unit-level strategies that minimize cost. Figure 2.2 illustrates the strategy levels of a single business company with a relatively simple business structure. A diversified, multibusiness company would also have an overarching corporate-level strategy beyond what is shown in Figure 2.2 to ensure consistency in strategy among all businesses in its portfolio.

Corporate strategy ensures consistency in strategic approach among businesses of a diversified, multibusiness corporation. **Business strategy** is primarily concerned with strengthening the company's market position and building competitive advantage in a single business company or a single business unit of a diversified multibusiness corporation.

FIGURE 2.2 **Strategy-Making Hierarchy for a Single Business Company**



A key element of the strategy-making hierarchy shown in Figure 2.2 is the two-way influence between management at various levels of the organization in crafting the business strategy. Managers at the top of the organization might have conceptualized a ground-breaking strategy capable of yielding significant marketplace advantages, but such plans may not match the current competitive capabilities of the organization. In many ways, managers closest to operations are in the best position to determine if an organization is capable of executing a planned strategy. You should conclude from examining the figure that strategy-making efforts require collaboration among managers throughout the organization and must be coordinated across functional areas to have a good chance of bringing success to the organization.

In most companies, crafting strategy is a **collaborative team effort** that includes managers in various positions and at various organizational levels. Crafting strategy is rarely something only high-level executives do.

As shown in Figure 2.2, a company's **business strategy** is the responsibility of the CEO and other senior executives and is primarily concerned with strengthening the company's market position and building competitive advantage. **Functional-area strategies** concern the actions related to particular functions or processes within a business. A company's product development strategy, for example, represents the managerial game plan for creating new products that are in tune with what buyers are looking for. Functional strategies add detail to the company's business-level strategy and specify what resources and organizational capabilities are needed to put the company's overall business strategy into action. Lead responsibility for functional strategies within a business is normally delegated to the heads of the respective functions, with the general manager of the business having final approval over functional strategies. For the overall business strategy to have maximum impact, a business's marketing strategy, production strategy, finance strategy, customer service strategy, product development strategy, and human resources strategy should be compatible and mutually reinforcing rather than each serving its own narrower purpose.

Operating strategies concern the relatively narrow strategic initiatives and approaches for managing key operating units (plants, distribution centers, geographic units) and specific operating activities such as materials purchasing or Internet sales. A distribution center manager of a company promising customers speedy deliveries must have a strategy to ensure that finished goods are rapidly turned around and shipped out to customers once they are received from the company's manufacturing facilities. Operating strategies are limited in scope, but add further detail to functional strategies and the overall business strategy. Lead responsibility for operating strategies is usually delegated to frontline managers, subject to review and approval by higher ranking managers.

As mentioned earlier in this section, the purpose of a **corporate strategy** is to ensure consistency in strategic approach among the businesses of a diversified, multibusiness corporation. Corporate strategy and business diversification are discussed in detail in Chapter 8. In short, winning corporate strategies build shareholder value by combining businesses to yield a $1 + 1 = 3$ effect. The best corporate strategies utilized in multibusiness companies identify attractive industries to diversify into, allocate financial resources to business units most likely to record above-average earnings, and capture cross-business cost sharing and skills transfer synergies. Senior corporate executives normally have lead responsibility for devising corporate strategy. Key business-unit heads may also be influential, especially in strategic decisions affecting the businesses they head. Major strategic decisions are usually reviewed and approved by the company's board of directors.

Implementing and Executing the Chosen Strategy: Stage 4 of the Strategic Management Process

Managing the implementation and execution of strategy is easily the most demanding and time-consuming part of the strategic management process. Good strategy execution entails that managers pay careful attention to how key internal business processes are performed and see to it that employees' efforts are directed toward the accomplishment of desired operational outcomes. The task of implementing and executing the strategy also necessitates an ongoing analysis of the efficiency and effectiveness of a company's internal activities and a managerial awareness of new technological developments that might improve business processes. In most situations, managing the strategy execution process includes the following principal aspects:

- Staffing the organization to provide needed skills and expertise.
- Allocating ample resources to activities critical to good strategy execution.
- Ensuring that policies and procedures facilitate rather than impede effec-tivee xecution.
- Installing information and operating systems that enable company personnel to perform essential activities.
- Pushing for continuous improvement in how value chain activities are performed.
- Tying rewards and incentives directly to the achievement of performance objectives.
- Creating a company culture and work climate conducive to successful strategye xecution.
- Exerting the internal leadership needed to propel implementation forward.

Evaluating Performance and Initiating Corrective Adjustments: Stage 5 of the Strategic Management Process

The fifth stage of the strategy management process—monitoring new external developments, evaluating the company's progress, and making corrective adjustments—is the trigger point for deciding whether to continue or change the company's vision, objectives, strategy, and/or strategy execution methods. So long as the company's direction and strategy seem well matched to industry and competitive conditions and performance targets are being met, company executives may well decide to stay the course. Simply fine-tuning the strategic plan and continuing with efforts to improve strategy execution are sufficient.

But whenever a company encounters disruptive changes in its environment, questions need to be raised about the appropriateness of its direction and strategy. If a company experiences a downturn in its market position or persistent shortfalls in performance, then company managers are obligated to ferret out the causes—do they relate to poor strategy, poor strategy execution, or both?—and take timely corrective action. A company's direction, objectives, and strategy have to be revisited any time external or internal conditions warrant.

> A company's vision, objectives, strategy, and approach to strategy execution are never final; managing strategy is an ongoing process, not an every-now-and-then task.

Also, it is not unusual for a company to find that one or more aspects of its strategy implementation and execution are not going as well as intended. Proficient strategy execution is always the product of much organizational learning. It is achieved unevenly—coming quickly in some areas and proving nettlesome in others. Successful strategy execution entails vigilantly searching for ways to improve and then making corrective adjustments whenever and wherever it is useful to do so.

Leading the Strategic Management Process

The litany of leading and managing the strategy process is simple enough: Craft a sound strategic plan, implement it, execute it to the fullest, adjust it as needed, and win! But the leadership challenges are significant and diverse. Exerting take-charge leadership and achieving results thrusts top executives and senior managers into a variety of leadership roles: visionary, strategist, resource acquirer, capabilities builder, motivator, and crisis solver to mention a few. There are times when leading the strategic management process entails being authoritarian and hardnosed, times when it is best to be a perceptive listener and a compromising decision maker, and times when matters are best delegated to people closest to the scene of the action.

In general, leading the strategic management process calls for several actions on the part of senior executives:

1. Making sure the company has a good strategic plan.
2. Staying on top of what is happening.
3. Putting constructive pressure on organizational units to achieve good results and operating excellence.
4. Pushing corrective actions to improve both the company's strategy and how well it is being executed.
5. Leading the development of stronger competitive capabilities.
6. Displaying ethical integrity and leading social responsibility initiatives.

MAKING SURE A COMPANY HAS A GOOD STRATEGIC PLAN It is the responsibility of top executives—most especially the CEO—to ensure that a company has a sound and cohesive strategic plan. There are two things that the CEO and other top-level executives should do in leading the development of a good strategic plan. One is to *effectively communicate the company's vision, objectives, and major strategy components* to down-the-line managers and key personnel. The greater the numbers of company personnel who know, understand, and buy into the company's long-term direction and overall strategy, the smaller the risk that organization units will go off in conflicting strategic directions. The second is to *exercise due diligence in reviewing lower-level strategies for consistency* and support of higher level strategies. Any strategy conflicts must be addressed and resolved, either by modifying the lower-level strategies with conflicting elements or by adapting the higher-level strategy to accommodate what may be more appealing strategy ideas and initiatives bubbling from below. *Anything less than a unified collection of strategies weakens the overall strategy and is likely to impair company performance.*

STAYING ON TOP OF HOW WELL THINGS ARE GOING One of the best ways for executives to stay on top of the strategy execution process is by making regular visits to the field and talking with many different people at many different levels—a technique often labeled *managing by walking around* **(**MBWA**).** Walmart executives have had a long-standing practice of spending two to three days every week visiting Walmart's stores and talking with store managers and employees. Sam Walton, Walmart's founder, insisted, "The key is to get out into the store and listen to what the associates have to say." Jack Welch, the highly effective CEO of General Electric (GE) from 1980 to 2001, not only spent several days each month personally visiting GE operations and talking with major customers, but also arranged his schedule so that he could spend time exchanging information and ideas with GE managers from all over the world who were attending classes at the company's leadership development center near GE's headquarters. Jeff Bezos, Amazon.com's CEO, is noted for his frequent facilities visits and his insistence that other Amazon managers spend time in the trenches with their people to prevent overly abstract thinking and getting disconnected from the reality of what's happening.[10]

Most managers practice MBWA, attaching great importance to gathering information from people at different organizational levels about how well various aspects of the strategy execution process are going. They believe facilities visits and face-to-face contacts give them a good feel for what progress is being made, what problems are being encountered, and whether additional resources or different approaches may be needed. Just as important, MBWA provides opportunities to give encouragement, lift spirits, shift attention from old to new priorities, and create excitement—all of which help mobilize organizational efforts behind strategy execution.

PUTTING CONSTRUCTIVE PRESSURE ON ORGANIZATIONAL UNITS TO ACHIEVE GOOD RESULTS AND OPERATING EXCELLENCE Managers have to be out front in mobilizing the effort for good strategy execution and operating excellence. Part of the leadership requirement here entails fostering a results-oriented work climate, where performance standards are high and a spirit of achievement is pervasive. Successfully leading the effort to foster a results-oriented, high performance culture generally entails such leadership actions and managerial practices as:

- *Treating employees with dignity and respect.*
- *Encouraging employees to use initiative and creativity in performing their work.*
- *Setting stretch objectives and clearly communicating an expectation that company personnel are to give their best in achieving performance targets.*
- *Focusing attention on continuous improvement.*
- *Using the full range of motivational techniques and compensation incentives to reward high performance.*
- *Celebrating individual, group, and company successes.* Top management should miss no opportunity to express respect for individual employees and show their appreciation of extraordinary individual and group effort.[11]

[10] Fred Vogelstein, "Winning the Amazon Way," *Fortune*, May 26, 2003, p. 64.

[11] Jeffrey Pfeffer, "Producing Sustainable Competitive Advantage through the Effective Management of People," *Academy of Management Executive* 9, no. 1 (February 1995), pp. 55–69.

While leadership efforts to instill a spirit of high achievement into the culture usually accentuate the positive, there are negative reinforcers too. Low-performing workers and people who reject the results-oriented cultural emphasis have to be weeded out or at least moved to out-of-the-way positions. Average performers have to be candidly counseled that they have limited career potential unless they show more progress in the form of additional effort, better skills, and improved ability to deliver good results. In addition, managers whose units consistently perform poorly have to be replaced.

PUSHING CORRECTIVE ACTIONS TO IMPROVE BOTH THE COMPANY'S STRATEGY AND HOW WELL IT IS BEING EXECUTED The leadership challenge of making corrective adjustments is twofold: deciding when adjustments are needed and deciding what adjustments to make. Both decisions are a normal and necessary part of managing the strategic management process, since no scheme for implementing and executing strategy can foresee all the events and problems that will arise.[12] There comes a time at every company when managers have to fine-tune or overhaul the company's strategy or its approaches to strategy execution and push for better results. Clearly, when a company's strategy or its execution efforts are not delivering good results, it is the leader's responsibility to step forward and push corrective actions.

LEADING THE DEVELOPMENT OF BETTER COMPETITIVE CAPABILITIES A company that proactively tries to strengthen its competitive capabilities not only adds power to its strategy and to its potential for winning competitive advantage but also enhances its chances for achieving good strategy execution and operating excellence. Senior management usually has to *lead* the strengthening effort because competencies and competitive capabilities are spawned by the combined efforts of different work groups, departments, and strategic allies. The tasks of developing human skills, knowledge bases, and intellectual assets and then integrating them to forge competitively advantageous competencies and capabilities is an exercise best orchestrated by senior managers who appreciate their significance and who have the clout to enforce the necessary cooperation among individuals, groups, departments, and external allies. Aside from leading efforts to strengthen *existing* competitive capabilities, effective strategy leadership also entails trying to anticipate changes in customer-market requirements and proactively build *new* competencies and capabilities that hold promise for building an enduring competitive edge over rivals. Senior managers are in the best position to see the need and potential of such new capabilities and then to play a lead role in the capability-building process.

DISPLAYING ETHICAL INTEGRITY AND LEADING SOCIAL RESPONSIBILITY INITIATIVES For an organization to avoid the pitfalls of scandal and disgrace related to unethical business practices, management

[12]For an excellent discussion of strategy as a dynamic process involving continuous, unending creation and re-creation of strategy, see Cynthia A. Montgomery, "Putting Leadership Back into Strategy," *Harvard Business Review* 86, no. 1 (January 2008), pp. 54–60.

must be openly and unswervingly committed to ethical conduct and socially redeeming business principles. Leading the effort to operate the company's business in an ethically principled fashion has three pieces.

- First and foremost, the CEO and other senior executives must set an excellent example in their own ethical behavior, demonstrating character and personal integrity in their actions and decisions. The behavior of senior executives is always watched carefully, sending a clear message to company personnel regarding what the "real" standards of personal conduct are.
- Second, top management must declare unequivocal support of the company's ethical code and take an uncompromising stand on expecting all company personnel to adhere to the company's ethical principles.
- Third, top management must be prepared to act as the final arbiter on hard calls; this means removing people from key positions or terminating them when they are guilty of a violation. It also means reprimanding those who have been lax in enforcing ethical compliance. Failure to act swiftly and decisively in punishing ethical misconduct is interpreted as a lack of real commitment.

The exercise of social responsibility, just as with observance of ethical principles, requires top executive leadership. What separates companies that make a sincere effort to be good corporate citizens from companies that are content to do only what is legally required are company leaders who believe strongly that just making a profit is not good enough. Such leaders are committed to a higher standard of performance that includes social and environmental metrics as well as financial and strategic metrics. The strength of the commitment from the top—typically a company's CEO and board of directors—ultimately determines whether a company will implement and execute a full-fledged strategy of social responsibility that protects the environment, actively participates in community affairs, supports charitable causes, and has a positive impact on workforce diversity and the overall well-being of employees.

Strategic Leadership from the Board of Directors

Although senior managers have *lead responsibility* for crafting and executing a company's strategy, it is the duty of the board of directors to exercise strong oversight and see that the five tasks of strategic management are done in a manner that benefits shareholders (in the case of investor-owned enterprises) or stakeholders (in the case of not-for-profit organizations). In watching over management's strategy-making, strategy-executing actions, a company's board of directors has four important corporate governance obligations to fulfill:

1. *Oversee the company's financial accounting and financial reporting practices.* While top management, particularly the company's CEO and CFO (chief financial officer), is primarily responsible for seeing that the company's financial statements accurately report the results of the company's

operations, board members have a fiduciary duty to protect shareholders by exercising oversight of the company's financial practices. In addition, corporate boards must ensure that generally acceptable accounting principles (GAAP) are properly used in preparing the company's financial statements and determine whether proper financial controls are in place to prevent fraud and misuse of funds. Virtually all boards of directors monitor the financial reporting activities by appointing an audit committee, always composed entirely of *outside directors* (*inside directors* hold management positions in the company and either directly or indirectly report to the CEO). The members of the audit committee have lead responsibility for overseeing the decisions of the company's financial officers and consulting with both internal and external auditors to ensure that financial reports are accurate and adequate financial controls are in place. Faulty oversight of corporate accounting and financial reporting practices by audit committees and corporate boards during the early 2000s resulted in the federal investigation of more than 20 major corporations between 2000 and 2002. The investigations of such well-known companies as AOL Time Warner, Global Crossing, Enron, Qwest Communications, and WorldCom found that upper management had employed fraudulent or unsound accounting practices to artificially inflate revenues, overstate assets, and reduce expenses. The scandals resulted in the conviction of a number of corporate executives and the passage of the Sarbanes-Oxley Act of 2002, which tightened financial reporting standards and created additional compliance requirements for public boards.

2. *Be inquiring critics and oversee the company's direction, strategy, and business approaches.* Even though board members have a legal obligation to warrant the accuracy of the company's financial reports, directors must set aside time to guide management in choosing a strategic direction and to make independent judgments about the validity and wisdom of management's proposed strategic actions. Many boards have found that meeting agendas become consumed by compliance matters and little time is left to discuss matters of strategic importance. The board of directors and management at Philips Electronics hold annual two- to three-day retreats devoted exclusively to evaluating the company's long-term direction and various strategic proposals. The company's exit from the semiconductor business in 2006 and its increased focus on medical technology and home health care resulted from management-board discussions during such retreats.[13]

3. *Evaluate the caliber of senior executives' strategy-making and strategy-executing skills.* The board is always responsible for determining whether the current CEO is doing a good job of strategic leadership and whether senior management is actively creating a pool of potential successors to the CEO and other top executives.[14] Evaluation of senior executives'

[13]As discussed in Jay W. Lorsch and Robert C. Clark, "Leading from the Boardroom," *Harvard Business Review* 86, no. 4 (April 2008), pp. 105–111.
[14]Ibid., p. 110.

Concepts & Connections 2.3

CORPORATE GOVERNANCE FAILURES AT FANNIE MAE AND FREDDIE MAC

Executive compensation in the financial services industry during the mid-2000s ranks high among examples of failed corporate governance. Corporate governance at the government-sponsored mortgage giants Fannie Mae and Freddie Mac was particularly weak. The politically appointed boards at both enterprises failed to understand the risks of the subprime loan strategies being employed, did not adequately monitor the decisions of the CEO, did not exercise effective oversight of the accounting principles being employed (which led to inflated earnings), and approved executive compensation systems that allowed management to manipulate earnings to receive lucrative performance bonuses. The audit and compensation committees at Fannie Mae were particularly ineffective in protecting shareholder interests, with the audit committee allowing the GSE's financial officers to audit reports prepared under their direction and used to determine performance bonuses. Fannie Mae's audit committee also was aware of management's use of questionable accounting practices that reduced losses and recorded one-time gains to achieve EPS targets linked to bonuses. In addition, the audit committee failed to investigate formal charges of accounting improprieties filed by a manager in the Office of the Controller.

Fannie Mae's compensation committee was equally ineffective. The committee allowed the company's CEO, Franklin Raines, to select the consultant employed to design the mortgage firm's executive compensation plan and agreed to a tiered bonus plan that would permit Raines and other senior managers to receive maximum bonuses without great difficulty. The compensation plan allowed Raines to earn performance-based bonuses of $52 million and total compensation of $90 million between 1999 and 2004. Raines was forced to resign in December 2004 when the Office of Federal Housing Enterprise Oversight found that Fannie Mae executives had fraudulently inflated earnings to receive bonuses linked to financial performance. Securities and Exchange Commission investigators also found evidence of improper accounting at Fannie Mae and required the GSE to restate its earnings between 2002 and 2004 by $6.3 billion.

Poor governance at Freddie Mac allowed its CEO and senior management to manipulate financial data to receive performance-based compensation as well. Freddie Mac CEO Richard Syron received 2007 compensation of $19.8 million while the mortgage company's share price declined from a high of $70 in 2005 to $25 at year-end 2007. During Syron's tenure as CEO the company become embroiled in a multibillion-dollar accounting scandal and Syron personally disregarded internal reports dating to 2004 that cautioned of an impending financial crisis at the company. Forewarnings within Freddie Mac and by federal regulators and outside industry observers proved to be correct, with loan underwriting policies at Freddie Mac and Fannie Mae leading to combined losses at the two firms in 2008 of more than $100 billion. The price of Freddie Mac's shares had fallen to below $1 by the time of Syron's resignation in September 2008.

Both organizations were placed into a conservatorship under the direction of the U.S. government in September 2008 and were provided bailout funds of nearly $60 billion by April 2009. In May 2009, Fannie Mae had requested another $19 billion of the $400 billion committed by the U.S. government to cover the operating losses of the two government-sponsored mortgage firms. As of June 2009, the U.S. government has spent more than $2.5 trillion to bail out financial institutions damaged by the subprime mortgage market and other risky loans and had made commitments totaling $12.2 trillion to provide long-term stability to the financial services industry.

Sources: "Adding Up the Government's Total Bailout Tab," *New York Times Online,* February 4, 2009; Eric Dash, "Fannie Mae to Restate Results by $6.3 billion because of Accounting," *New York Times Online,* www.nytimes.com, December 7, 2006; Annys Shin, "Fannie Mae Sets Executive Salaries," *Washington Post,* February 9, 2006, p. D4; and Scott DeCarlo, Eric Weiss, Mark Jickling, and James R. Cristie, *Fannie Mae and Freddie Mac: Scandal in U.S. Housing* (Nova Publishers, 2006), pp. 266–286.

strategy-making and strategy-executing skills is enhanced when outside directors go into the field to personally evaluate how well the strategy is being executed. Independent board members at GE visit operating executives at each major business unit once per year to assess the company's talent pool and stay abreast of emerging strategic and operating issues affecting the company's divisions. Home Depot board members visit a store once per quarter to determine the health of the company's operations.[15]

4. *Institute a compensation plan for top executives that rewards them for actions and results that serve shareholder interests.* A basic principle of corporate governance is that the owners of a corporation delegate operating authority and managerial control to top management in return for compensation. In their role as an *agent* of shareholders, top executives have a clear and unequivocal duty to make decisions and operate the company in accord with shareholder interests (but this does not mean disregarding the interests of other stakeholders, particularly those of employees, with whom they also have an agency relationship). Most boards of directors have a compensation committee, composed entirely of outside directors, to develop salary and incentive compensation plans that make it in the self-interest of executives to operate the business in a manner that benefits the owners. It is also incumbent on the board of directors to prevent management from gaining executive perks and privileges that simply line the financial pockets of executives. Concepts & Connections 2.3 discusses how weak governance at Fannie Mae and Freddie Mac allowed opportunistic senior managers to secure excessive, if not obscene, compensation, while making decisions that imperiled the futures of the companies they managed.

Every corporation should have a strong, independent board of directors that (1) is well-informed about the company's performance, (2) guides and judges the CEO and other top executives, (3) has the courage to curb management actions they believe are inappropriate or unduly risky, (4) certifies to shareholders that the CEO is doing what the board expects, (5) provides insight and advice to management, and (6) is intensely involved in debating the pros and cons of key decisions and actions.[16] Boards of directors that lack the backbone to challenge a strong-willed or "imperial" CEO or that rubberstamp most anything the CEO recommends without probing inquiry and debate abandon their duty to represent and protect shareholder interests.

[15] As discussed in Stephen P. Kaufman, "Evaluating the CEO," *Harvard Business Review* 86, no. 10 (October 2008), pp. 53–57.

[16] For a discussion of what it takes for the corporate governance system to function properly, see David A. Nadler, "Building Better Boards," *Harvard Business Review* 82, no. 5 (May 2004), pp. 102–105; Cynthia A. Montgomery and Rhonda Kaufman, "The Board's Missing Link," *Harvard Business Review* 81, no. 3 (March 2003), pp. 86–93; and John Carver, "What Continues to Be Wrong with Corporate Governance and How to Fix It," *Ivey Business Journal* 68, no. 1 (September/October 2003), pp. 1–5. See also Gordon Donaldson, "A New Tool for Boards: The Strategic Audit," *Harvard Business Review* 73, no. 4 (July–August 1995), pp. 99–107.

KeyP oints

The strategic management process consists of five interrelated and integrated stages:

1. *Developing a strategic vision* of where the company needs to head and what its future product-customer-market-technology focus should be. This managerial step provides long-term direction, infuses the organization with a sense of purposeful action, and communicates to stakeholders management's aspirations for the company.
2. *Setting objectives* and using the targeted results as yardsticks for measuring the company's performance. Objectives need to spell out *how much* of *what kind*o f performance *by when.* A *balanced scorecard* approach for measuring company performance entails setting both *financial objectives and strategic objectives.*
3. *Crafting a strategy to achieve the objectives* and move the company along the strategic course that management has charted. The total strategy that emerges is really a collection of strategic actions and business approaches initiated partly by senior company executives, partly by the heads of major business divisions, partly by functional-area managers, and partly by operating managers on the frontlines. A single business enterprise has three levels of strategy—business strategy for the company as a whole, functional-area strategies for each main area within the business, and operating strategies undertaken by lower-echelon managers. In diversified, multibusiness companies, the strategy-making task involves four distinct types or levels of strategy: corporate strategy for the company as a whole, business strategy (one for each business the company has diversified into), functional-area strategies within each business, and operating strategies. Typically, the strategy-making task is more top-down than bottom-up, with higher-level strategies serving as the guide for developing lower-level strategies.
4. *Implementing and executing the chosen strategy efficiently and effectively.*M anaging the implementation and execution of strategy is an operations-oriented, make-things-happen activity aimed at shaping the performance of core business activities in a strategy supportive manner. Management's handling of the strategy implementation process can be considered successful if things go smoothly enough that the company meets or beats its strategic and financial performance targets and shows good progress in achieving management's strategic vision.
5. *Evaluating performance and initiating corrective adjustments* in vision, long-term direction, objectives, strategy, or execution in light of actual experience, changing conditions, new ideas, and new opportunities. This stage of the strategy management process is the trigger point for deciding whether to continue or change the company's vision, objectives, strategy, and/or strategy execution methods.

The sum of a company's strategic vision, objectives, and strategy constitutes a *strategic plan.*

Managers must demonstrate strong leadership to push strategy formulation and execution forward. In general, leading the drive for good strategy making and strategy execution calls for six actions on the part of the manager in charge:

1. Making sure the company has a good strategic plan.
2. Staying on top of what is happening.
3. Putting constructive pressure on organizational units to achieve good results and operatinge xcellence.
4. Pushing corrective actions to improve both the company's strategy and how well it is being executed.

5. Leading the development of stronger competitive capabilities.
6. Displaying ethical integrity and leading social responsibility initiatives.

Boards of directors have a duty to shareholders to play a vigilant role in overseeing management's handling of a company's strategy-making, strategy-executing process. A company's board is obligated to (1) ensure that the company issues accurate financial reports and has adequate financial controls, (2) critically appraise and ultimately approve strategic action plans, (3) evaluate the strategic leadership skills of the CEO, and (4) institute a compensation plan for top executives that rewards them for actions and results that serve stakeholder interests, most especially those of shareholders.

Assurance of Learning Exercises

LO1 1. Using the information in Tables 2.2 and 2.3, critique the adequacy and merit of the following vision statements, listing effective elements and shortcomings. Rank the vision statements from best to worst once you complete your evaluation.

VISION STATEMENT	EFFECTIVE ELEMENTS	SHORTCOMINGS
Wells Fargo We want to satisfy all of our customers' financial needs, help them succeed financially, be the premier provider of financial services in every one of our markets, and be known as one of America's great companies.		
Hilton Hotels Corporation Our vision is to be the first choice of the world's travelers. Hilton intends to build on the rich heritage and strength of our brands by: • Consistently delighting our customers • Investing in our team members • Delivering innovative products and services • Continuously improving performance • Increasing shareholder value • Creating a culture of pride • Strengthening the loyalty of our constituents		
H. J. Heinz Company Be the world's premier food company, offering nutritious, superior tasting foods to people everywhere. Being the premier food company does not mean being the biggest but it does mean being the best in terms of consumer value, customer service, employee talent, and consistent and predictable growth.		
Chevron To be *the* global energy company most admired for its people, partnership and performance. Our vision means we: • provide energy products vital to sustainable economic progress and human development throughout the world; • are people and an organization with superior capabilities and commitment; • are the partner of choice; • deliver world-class performance; • earn the admiration of all our stakeholders–investors, customers, host governments, local communities and our employees–not only for the goals we achieve but how we achieve them.		

Source: Company Web sites and annual reports.

2. Go to www.dell.com/speeches and read Michael Dell's recent speeches. Do Michael Dell's speeches provide evidence that he is an effective leader at Dell Computer? Is there evidence he is concerned with (1) staying on top of what is happening and identifying obstacles to good strategy execution, (2) pushing the organization to achieve good results and operating excellence, and (3) displaying ethical integrity and spearheading social responsibility initiatives? **LO5**
3. Go to www.dell.com/leadership and read the sections dedicated to its board of directors and corporate governance. Is there evidence of effective governance at Dell in regard to (1) accurate financial reports and controls, (2) a critical appraisal of strategic action plans, (3) evaluation of the strategic leadership skills of the CEO, and (4) executive compensation? **LO7**

Exercisesf or Simulation Participants

1. Meet with your co-managers and prepare a strategic vision statement for your company. It should be at least one sentence long and no longer than a brief paragraph. When you are finished, check to see if your vision statement meets the conditions for an effectively worded strategic vision set forth in Table 2.2 and avoids the shortcomings set forth in Table 2.3. If not, then revise it accordingly. What would be a good slogan that captures the essence of your strategic vision and that could be used to help communicate the vision to company personnel, shareholders, and other stakeholders? **LO1**
2. What are your company's financial objectives? What are your company's strategico bjectives? **LO2**
3. What are the 3-4 key elements of your company's strategy? **LO3**

Chapter 3

Evaluating a Company's External Environment

Chapter Learning Objectives

LO1. Gain command of the basic concepts and analytical tools widely used to diagnose a company's industry and competitive conditions.

LO2. Become adept at recognizing the factors that cause competition in an industry to be fierce, more or less normal, or relatively weak.

LO3. Learn how to determine whether an industry's outlook presents a company with sufficiently attractive opportunities for growth and profitability.

In the opening paragraph of Chapter 1, we said that one of the three central questions that managers must address in evaluating their company's business prospects is "*Where are we now?*" Two facets of the company's situation are especially pertinent: (1) the industry and competitive environments in which the company operates and (2) the company's collection of competitively valuable resources and capabilities, its strengths and weaknesses vis-à-vis rivals, and its windows of opportunity. Developing answers to the questions "*Where do we want to go?*" and "*How are we going to get there?*" without first gaining an understanding of the company's external environment and internal situation hamstrings attempts to build competitive advantage and boost company performance. Indeed, the first test of a winning strategy inquires "*Does the strategy fit the company's situation?*"

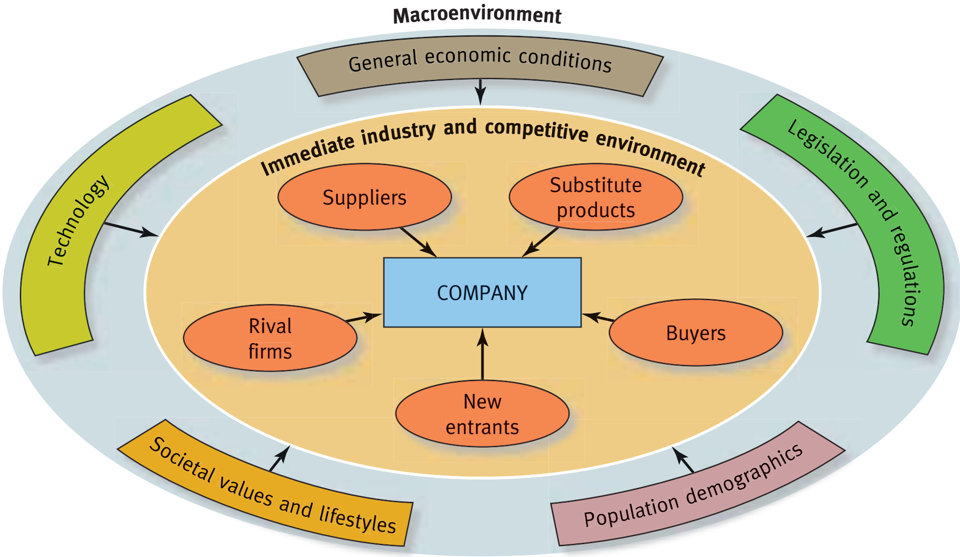
This chapter presents the concepts and analytical tools for zeroing in on a single-business company's external environment. Attention centers on the competitive arena in which the company operates, the drivers of market change, and rival companies' actions. In Chapter 4 we explore the methods of evaluating a company's internal circumstances and competitiveness.

Company Performance and the "Macroenvironment"

The performance of all companies is affected by such external factors as the economy at large, population demographics, societal values and lifestyles, governmental legislation and regulation, and technological factors. Strictly speaking, a company's "macroenvironment" includes *all relevant factors and influences* outside the company's boundaries; by *relevant*, we mean these factors are important enough that they should shape management's decisions regarding the company's long-term direction, objectives, strategy, and business model. Figure 3.1 presents a depiction of macroenvironmental factors with a high potential to affect a company's business situation. The impact of outer-ring factors on a company's choice of strategy can range from big to small. But even if the factors in the outer ring of the macroenvironment change slowly or are likely to have a low impact on the company's business situation, they still merit a watchful eye. Motor vehicle companies must adapt their strategies to current customer concerns about carbon emissions and high gasoline prices. The demographics of an aging population and longer life expectancies will have a dramatic impact on the health care and prescription drug industries in the next few decades. As company managers scan the external environment, they must be alert for potentially important outer-ring developments, assess their impact and influence, and adapt the company's direction and strategy as needed.

However, the factors and forces in a company's macroenvironment that have the *biggest* strategy-shaping impact typically pertain to the company's immediate industry and competitive environment—competitive pressures, the actions of rivals firms, buyer behavior, supplier-related considerations, and so on. Consequently, it is on a company's industry and competitive environment that we concentrate our attention in this chapter.

FIGURE 3.1 **The Components of a Company's Macroenvironment**



Assessing the Company's Industry and Competitive Environment

Thinking strategically about a company's industry and competitive environment entails using some well-validated concepts and analytical tools to get clear answers to seven questions:

1. What are the industry's dominant economic characteristics?
2. What kinds of competitive forces are industry members facing, and how strong is each force?
3. What forces are driving industry change, and what impact will these changes have on competitive intensity and industry profitability?
4. What market positions do industry rivals occupy—who is strongly positioned and who is not?
5. What strategic moves are rivals likely to make next?
6. What are the key factors of competitive success?
7. Does the industry outlook offer good prospects for profitability?

Analysis-based answers to these questions are prerequisites for a strategy offering good fit with the external situation. The remainder of this chapter is devoted to describing the methods of obtaining solid answers to the seven questions above.

Question 1: What Are the Industry's Dominant Economic Characteristics?

Analyzing a company's industry and competitive environment begins with identifying the industry's dominant economic characteristics. An industry's dominant economic features are defined by such factors as market size and growth rate, the number and size of buyers and sellers, the geographic boundaries of the market (which can extend from local to worldwide), whether sellers' products are virtually identical or highly differentiated, number of rival sellers, the pace of product innovation, market demand-supply conditions, the pace of technological change, the extent of vertical integration, and the extent to which costs are affected by scale economies (i.e., situations in which large-volume operations result in lower unit costs) and learning/experience curve effects (i.e., situations in which costs decline as a company gains knowledge and experience). Table 3.1 provides a summary of analytical questions that define the industry's dominant economic features.

Getting a handle on an industry's distinguishing economic features not only provides a broad overview of the attractiveness of the industry, but also promotes understanding of the kinds of strategic moves that industry members are likely to employ. For example, industries characterized by rapid product innovations require substantial investments in R&D and the development of strong product innovation capabilities—continuous product innovation is primarily a survival strategy in such industries as video games, computers, and pharmaceuticals. Industries with strong *learning/experience curve* effects are unlikely to experience entry of new competitors because any newcomer would be at a competitive disadvantage for an extended period of time. The microprocessor industry is an excellent example of how learning/experience curves put new entrants at a substantial cost disadvantage. Manufacturing unit costs for microprocessors tend to decline about 20 percent each time *cumulative* production volume doubles. With a 20 percent experience curve effect, if the first 1 million chips cost $100 each, once production volume reaches 2 million the unit cost would fall to $80 (80 percent of $100), and by a production volume of 4 million the unit cost would be $64 (80 percent of $80).[1] The bigger the learning or experience curve effect, the bigger the cost advantage of the company with the largest *cumulative* production volume.

Question 2: How Strong Are the Industry's Competitive Forces?

After gaining an understanding of the industry's general economic characteristics, industry and competitive analysis should focus on the competitive dynamics of the industry. The nature and subtleties of competitive forces are never the same from one industry to another and must be wholly understood to accurately form answers to the question "*Where are we now?*" Far and away the most powerful and widely used tool for assessing the strength of the industry's

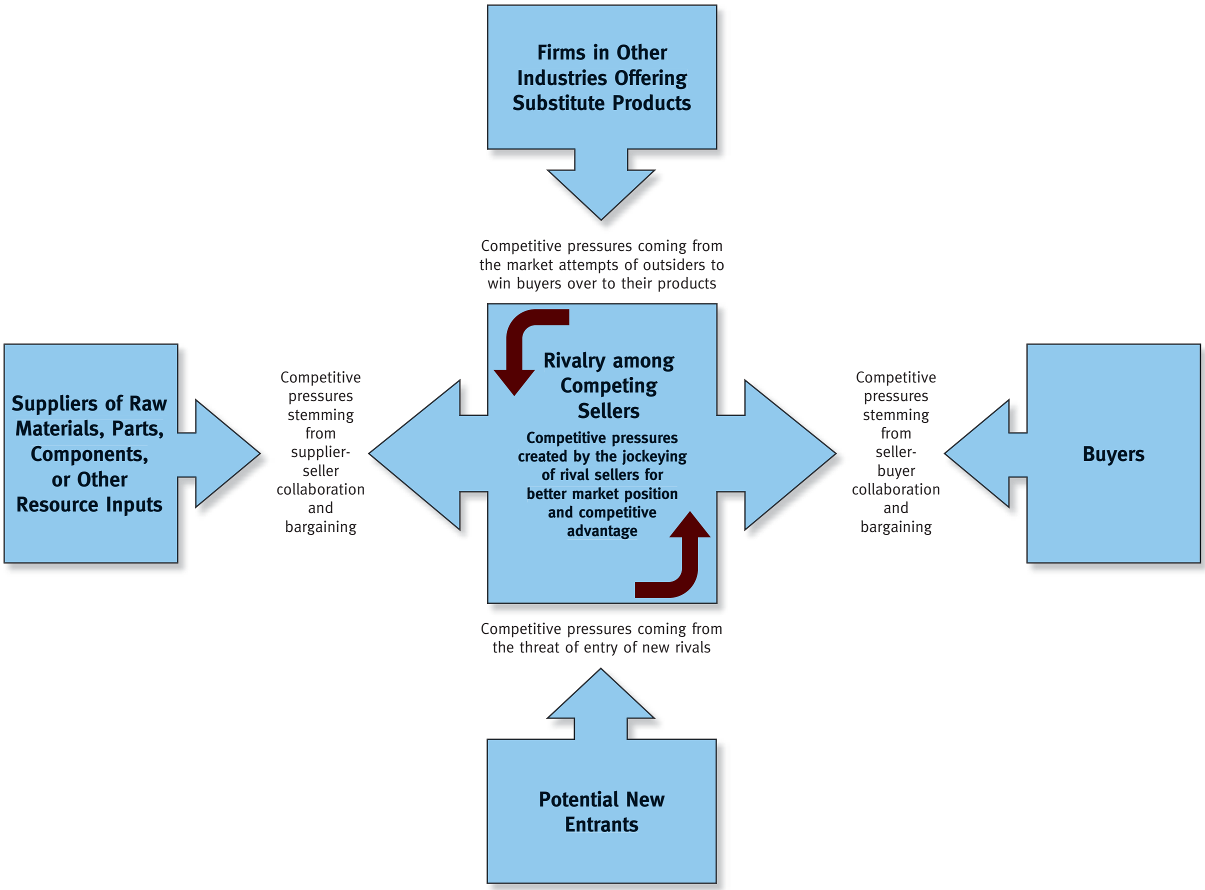
[1] There are a large number of studies on the size of the cost reductions associated with experience; the median cost reduction associated with a doubling of cumulative production volume is approximately 15%, but there is a wide variation from industry to industry. For a good discussion of the economies of experience and learning, see Pankaj Ghemawat, "Building Strategy on the Experience Curve," *Harvard Business Review* 64, no. 2 (March–April 1985), pp. 143–149.

Table 3.1

What to Consider in Identifying an Industry's Dominant Economic Features

ECONOMIC CHARACTERISTIC	QUESTIONS TO ANSWER
Market size and growth rate	• How big is the industry and how fast is it growing? • What does the industry's position in the life-cycle (early development, rapid growth and takeoff, early maturity and slowing growth, saturation and stagnation, decline) reveal about the industry's growth prospects?
Number of rivals	• Is the industry fragmented into many small companies or concentrated and dominated by a few large companies? • Is the industry going through a period of consolidation to a smaller number of competitors?
Scope of competitive rivalry	• Is the geographic area over which most companies compete local, regional, national, multinational, or global?
Number of buyers	• Is market demand fragmented among many buyers?
Degree of product differentiation	• Are the products of rivals becoming more differentiated or less differentiated?
Product innovation	• Is the industry characterized by rapid product innovation and short product life-cycles? • How important is R&D and product innovation? • Are there opportunities to overtake key rivals by being first-to-market with next-generation products?
Demand-supply conditions	• Is a surplus of capacity pushing prices and profit margins down? • Is the industry overcrowded with too many competitors?
Pace of technological change	• What role does advancing technology play in this industry? • Do most industry members have or need strong technological capabilities? Why?
Vertical integration	• Do most competitors operate in only one stage of the industry (parts and components production, manufacturing and assembly, distribution, retailing) or do some competitors operate in multiple stages? • Is there any cost or competitive advantage or disadvantage associated with being fully or partially integrated?
Economies of scale	• Is the industry characterized by economies of scale in purchasing, manufacturing, advertising, shipping, or other activities? • Do companies with large-scale operations have an important cost advantage over small-scale firms?
Learning and experience curve effects	• Are certain industry activities characterized by strong learning and experience curve effects? • Do any companies have significant cost advantages because of their learning/experience in performing particular activities?

FIGURE 3.2 **The Five-Forces Model of Competition**



Source: Based on Michael E. Porter, "How Competitive Forces Shape Strategy," *Harvard Business Review* 57, no. 2 (March–April 1979), pp. 137–45; and Michael E. Porter, "The Five Competitive Forces That Shape Strategy," *Harvard Business Review* 86, no. 1 (January 2008), pp. 80–86.

competitive forces is the *five-forces model of competition*.[2] This model, as depicted in Figure 3.2, holds that competitive forces affecting industry attractiveness go beyond rivalry among competing sellers and include pressures stemming from four coexisting sources. The five competitive forces affecting industry attractiveness are listed below.

1. Competitive pressures stemming from *buyer* bargaining power and seller-buyerc ollaboration.
2. Competitive pressures coming from companies in other industries to win buyers over to *substitute products*.

[2] The five-forces model of competition is the creation of Professor Michael Porter of the Harvard Business School. For his original presentation of the model, see Michael E. Porter, "How Competitive Forces Shape Strategy," *Harvard Business Review* 57, no. 2 (March–April 1979), pp. 137–145. A more thorough discussion can be found in Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980), chapter 1. Porter's five-forces model of competition is reaffirmed and extended in "The Five Competitive Forces That Shape Strategy," *Harvard Business Review* 86, no. 1 (January 2008), pp. 78–93.

3. Competitive pressures stemming from *supplier* bargaining power and supplier-sellerc ollaboration.
4. Competitive pressures associated with the threat of *new entrants* into the market.
5. Competitive pressures associated with *rivalry among competing sellers* to attract customers. This is usually the strongest of the five competitive forces.

TheC ompetitiveF orceo fB uyer Bargaining Power and Seller-Buyer Collaboration

Whether seller-buyer relationships represent a minor or significant competitive force depends on (1) whether some or many buyers have sufficient bargaining leverage to obtain price concessions and other favorable terms, and (2) the extent and importance of seller-buyer strategic partnerships in the industry.

FACTORS AFFECTING BUYER BARGAINING POWER The leverage that buyers have in negotiating favorable terms of the sale can range from weak to strong. Individual consumers, for example, rarely have much bargaining power in negotiating price concessions or other favorable terms with sellers. The primary exceptions involve situations in which price haggling is customary, such as the purchase of new and used motor vehicles, homes, and other big-ticket items like jewelry and pleasure boats. For most consumer goods and services, individual buyers have no bargaining leverage—their option is to pay the seller's posted price, delay their purchase until prices and terms improve, or take their business elsewhere.

In contrast, large retail chains like Walmart, Best Buy, Staples, and Home Depot typically have considerable negotiating leverage in purchasing products from manufacturers because retailers usually stock just two or three competing brands of a product and rarely carry all competing brands. In addition, the strong bargaining power of major supermarket chains like Kroger, Safeway, and Albertsons allows them to demand promotional allowances and lump-sum payments (called slotting fees) from food products manufacturers in return for stocking certain brands or putting them in the best shelf locations. Motor vehicle manufacturers have strong bargaining power in negotiating to buy original equipment tires from Goodyear, Michelin, Bridgestone/Firestone, Continental, and Pirelli not only because they buy in large quantities, but also because tire makers have judged original equipment tires to be important contributors to brand awareness and brand loyalty.

Even if buyers do not purchase in large quantities or offer a seller important market exposure or prestige, they gain a degree of bargaining leverage in the followingc ircumstances:[3]

- *If buyers' costs of switching to competing brands or substitutes are relatively low*—Buyers who can readily switch between several sellers have more negotiating leverage than buyers who have high switching costs. When the products of rival sellers are virtually identical, it is relatively easy for

[3] Porter, *Competitive Strategy*, pp. 24–27; and Porter, "The Five Competitive Forces That Shape Strategy," pp. 83–84.

buyers to switch from seller to seller at little or no cost. For example, the screws, rivets, steel, and capacitors used in the production of large home appliances like washers and dryers are all commoditylike and available from many sellers. The potential for buyers to easily switch from one seller to another encourages sellers to make concessions to win or retain a buyer'sb usiness.

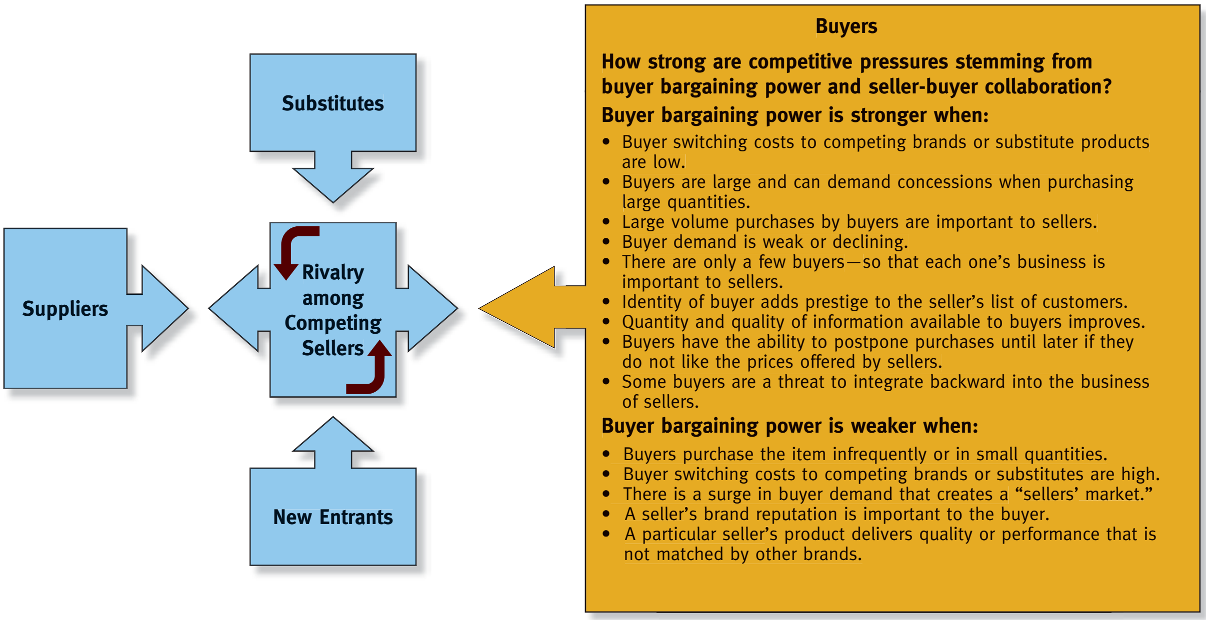
- *If the number of buyers is small or if a customer is particularly important to a seller*—The smaller the number of buyers, the less easy it is for sellers to find alternative buyers when a customer is lost to a competitor. The prospect of losing a customer who is not easily replaced often makes a seller more willing to grant concessions of one kind or another. Because of the relatively small number of digital camera brands, the sellers of lenses and other components used in the manufacture of digital cameras are in a weak bargaining position in their negotiations with buyers of their components.
- *If buyer demand is weak*—Weak or declining demand creates a "buyers' market"; conversely, strong or rapidly growing demand creates a "sellers' market" and shifts bargaining power to sellers.
- *If buyers are well-informed about sellers' products, prices, and costs*—The more information buyers have, the better bargaining position they are in. The mushrooming availability of product information on the Internet is giving added bargaining power to individuals. It has become commonplace for automobile shoppers to arrive at dealerships armed with invoice prices, dealer holdback information, a summary of incentives, and manufacturers' financing terms.
- *If buyers pose a credible threat of integrating backward into the business of sellers*—Companies like Anheuser-Busch, Coors, and Heinz have integrated backward into metal can manufacturing to gain bargaining power in obtaining the balance of their can requirements from otherwise powerfulm etalc anm anufacturers.

Figure 3.3 provides a summary of factors causing buyer bargaining power to be strong or weak.

A final point to keep in mind is that *not all buyers of an industry's product have equal degrees of bargaining power with sellers,* and some may be less sensitive than others to price, quality, or service differences. For example, apparel manufacturers confront significant bargaining power when selling to big retailers like Macy's, T. J. Maxx, or Target, but they can command much better prices selling to small owner-managed apparel boutiques.

SELLER-BUYER PARTNERSHIPS AND THE COMPETITIVE POWER OF BUYERS Partnerships between sellers and buyers are an increasingly important element of the competitive picture in *business-to-business relationships* (as opposed to business-to-consumer relationships). Many sellers that provide items to business customers have found it in their mutual interest to collaborate closely with buyers on such matters as just-in-time deliveries, order processing, electronic invoice payments, and data sharing. Many processed food and household products sellers have entered into partnerships

FIGURE 3.3 **Factors Affecting the Strength of Buyer Bargaining Power**



with large supermarket and discount store buyers to improve the efficiency of their outbound logistics and to boost sales volumes. Such partnerships also benefit buyers by ensuring merchandise is in stock and inventory costs are minimized. Walmart allows its vendors like Procter & Gamble, Sara Lee, and Unilever to monitor store bar code scanner data to determine when and what sized shipments to Walmart's distribution centers are needed. In some instances, sellers ship inventory directly to each Walmart store as merchandise is sold and shelves become depleted. Walmart's transition from using bar codes to radio frequency identification (RFID) was welcomed by sellers who saw an opportunity to boost sales of their products in Walmart stores. RFID receivers in each Walmart store or distribution center allowed sellers to track RFID-tagged inventory by number and location. Procter & Gamble and other sellers could then connect to Walmart's computer networks to watch the real-time inventory flow of items sold to Walmart and make just-in-time shipments to prevent inventory stockouts.

The Competitive Force of Substitute Products

Companies in one industry are vulnerable to competitive pressure from the actions of companies in another industry whenever buyers view the products of the two industries as good substitutes. For instance, the producers of sugar experience competitive pressures from the sales and marketing efforts of the makers of Equal, Splenda, and Sweet'N Low. Similarly, the producers of eyeglasses and contact lenses face competitive pressures from doctors who do corrective laser surgery. First-run movie theater chains are feeling competitive heat as more and more consumers are attracted to simply watch video-on-demand or movie DVDs at home in media rooms equipped with big-screen, high definition TVs and surround sound. The producers of metal cans are becoming increasingly engaged in a battle with the makers of retort pouches for the business of companies producing packaged fruits, vegetables, meats, and pet foods. Retort pouches, which are multilayer packages made from polypropylene, aluminum foil, and polyester, are more attractively priced than metal cans because they are less expensive to produce and ship than cans.

Just how strong the competitive pressures are from the sellers of substitute products depends on three factors:

1. *Whether substitutes are readily available and attractively priced.* The presence of readily available and attractively priced substitutes creates competitive pressure by placing a ceiling on the prices industry members can charge.[4] When substitutes are cheaper than an industry's product, industry members come under heavy competitive pressure to reduce their prices and find ways to absorb the price cuts with cost reductions.
2. *Whether buyers view the substitutes as comparable or better in terms of quality, performance, and other relevant attributes.* Customers are prone to compare performance and other attributes as well as price. For example, consumers have found digital cameras to be a superior substitute to film cameras because of the superior ease of use, the ability to download images to a home computer, and the ability to delete bad shots without paying for filmd eveloping.
3. *Whether the costs that buyers incur in switching to the substitutes are high or low.* High switching costs deter switching to substitutes while low switching costs make it easier for the sellers of attractive substitutes to lure buyers to their products.[5] Typical switching costs include the inconvenience of switching to a substitute, the costs of additional equipment, the psychological costs of severing old supplier relationships, and employee retraining costs.

Figure3.4 summarizes the conditions that determine whether the competitive pressures from substitute products are strong, moderate, or weak. As a rule, the lower the price of substitutes, the higher their quality and performance, and the lower the user's switching costs, the more intense the competitive pressures posed by substitute products.

The Competitive Force of Supplier Bargaining Power and Supplier-Seller Collaboration

Whether supplier-seller relationships represent a weak or strong competitive force depends on (1) the extent to which suppliers are able to shape the terms and conditions of sales of the items they supply to an industry and (2) the nature and extent of supplier-seller collaboration in the industry.

[4] Porter, "How Competitive Forces Shape Strategy," p. 142; Porter, *Competitive Strategy*, pp. 23–24; and Porter, "The Five Competitive Forces That Shape Strategy," pp. 82–83.
[5] Porter, *Competitive Strategy*, p. 10; and Porter, "The Five Competitive Forces That Shape Strategy," p. 85.

FIGURE 3.4 **Factors Affecting Competition from Substitute Products**

Firms in Other Industries Offering Substitute Products

How strong are competitive pressures coming from substitute products from outside the industry?

Competitive pressures from substitutes are stronger when:

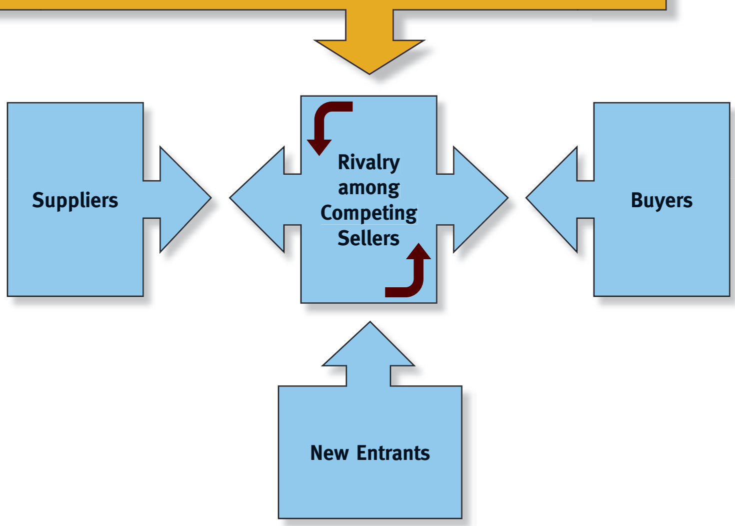
- Good substitutes are readily available or new ones are emerging.
- Substitutes are attractively priced.
- Substitutes have comparable or better performance features.
- End users have low costs in switching to substitutes.
- End users grow more comfortable with using substitutes.

Competitive pressures from substitutes are weaker when:

- Good substitutes are not readily available or don't exist.
- Substitutes are higher priced relative to the performance they deliver.
- End users have high costs in switching to substitutes.

Signs that Competition from Substitutes Is Strong

- Sales of substitutes are growing faster than sales of the industry being analyzed (an indication that the sellers of substitutes are drawing customers away from the industry in question).
- Producers of substitutes are moving to add new capacity.
- Profits of the producers of substitutes are on the rise.



FACTORS INFLUENCING SUPPLIER BARGAINING POWER Certain conditions exist that make it possible for industry suppliers to exert competitive pressure on one or more rival sellers. For instance, Microsoft and Intel, both of whom supply PC makers with essential components, have been known to use their dominant market status not only to charge PC makers premium prices but also to leverage PC makers in other ways. The bargaining power possessed by Microsoft and Intel when negotiating with customers is so great that both companies have faced antitrust charges on numerous occasions. Prior to a legal agreement ending the practice in 2001, Microsoft pressured PC makers to load only Microsoft products on the PCs they shipped. Intel has also defended against antitrust charges resulting from its bargaining strength, but continues to give PC makers who use the biggest percentages of Intel chips in their PC models top priority in filling orders for newly introduced Intel chips. Being on Intel's list of preferred customers helps a PC maker get an early allocation of Intel's latest chips and thus allows a PC maker to get new models to market ahead of rivals.

The factors that determine whether any of the industry suppliers are in a position to exert substantial bargaining power or leverage are fairly clear-cut:[6]

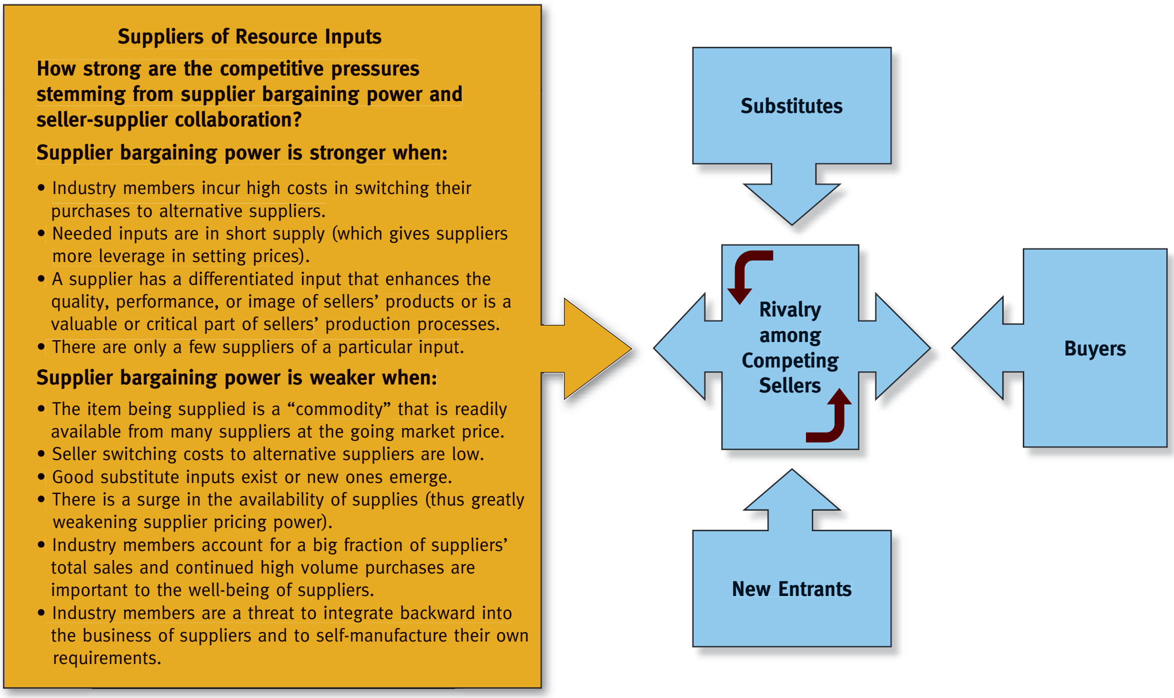
- *If the item being supplied is a commodity that is readily available from many suppliers.* Suppliers have little or no bargaining power or leverage whenever industry members have the ability to source from any of several alternative and eager suppliers.
- *The ability of industry members to switch their purchases from one supplier to another or to switch to attractive substitutes.* High switching costs increase supplier bargaining power, whereas low switching costs and the ready availability of good substitute inputs weaken supplier bargaining power.
- *If certain inputs are in short supply.* Suppliers of items in short supply have some degree of pricing power.
- *If certain suppliers provide a differentiated input that enhances the performance, quality, or image of the industry's product.* The greater the ability of a particular input to enhance a product's performance, quality, or image, the more bargaining leverage its suppliers are likely to possess.
- *Whether certain suppliers provide equipment or services that deliver cost savings to industry members in conducting their operations.* Suppliers who provide cost-saving equipment or services are likely to possess some degree of bargainingl everage.
- *The fraction of the costs of the industry's product accounted for by the cost of a particular input.* The bigger the cost of a specific part or component, the more opportunity for competition in the marketplace to be affected by the actions of suppliers to raise or lower their prices.
- *If industry members are major customers of suppliers.* As a rule, suppliers have less bargaining leverage when their sales to members of this one industry constitute a big percentage of their total sales. In such cases, the well-being of suppliers is closely tied to the well-being of their major customers.
- *Whether it makes good economic sense for industry members to vertically integrate backward.* The make-or-buy decision generally boils down to whether suppliers are able to supply a particular component at a lower cost than industry members could achieve if they were to integrate backward.

Figure3.5 summarizes the conditions that tend to make supplier bargaining power strong or weak.

HOW SELLER-SUPPLIER PARTNERSHIPS AFFECT COMPETITIVE PRESSURES Just as sellers benefit from strategic partnerships with buyers, collaboration with suppliers may also prove rewarding for sellers. In many industries, strategic partnerships with suppliers allow sellers to (1) reduce inventory and logistics costs (e.g., through just-in-time deliveries), (2) speed the availability of next-generation components, (3) enhance the quality of the

[6] Porter, *Competitive Strategy*, pp. 27–28; and Porter, "The Five Competitive Forces That Shape Strategy," pp. 82–83.

FIGURE 3.5 **Factors Affecting the Strength of Supplier Bargaining Power**



parts and components being supplied, and (4) squeeze out important cost savings for both themselves and their suppliers. Dell Computer has entered into strategic partnerships with its key suppliers to ensure its just-in-time deliveries of PC components arrive when needed. In some instances, Dell receives just-in-time delivery of computer parts every few hours. Many of Dell's key suppliers have built plants and distribution centers within a few miles of Dell assembly plants to meet these demanding delivery requirements. In addition, close relationships with suppliers allow Dell Computer to reduce the likelihood of recalled computers or production slowdowns. Many Dell suppliers assign engineers to Dell assembly plants to quickly resolve production-related problems as they occur. The more opportunities that exist for win-win efforts between a company and its suppliers, the less their relationship is characterized by who has the upper hand in bargaining with the other.

The Competitive Force of Potential New Entrants

Several factors determine whether the threat of new companies entering the marketplace presents a significant competitive pressure. One factor relates to the size of the pool of likely entry candidates and the resources at their command. As a rule, the bigger the pool of entry candidates, the stronger the threat of potential entry. This is especially true when some of the likely entry candidates have ample resources to support entry into a new line of business. Frequently, the strongest competitive pressures associated with potential entry come not from outsiders but from current industry participants looking for growth opportunities. *Existing industry members are often strong candidates to* *enter market segments or geographic areas where they currently do not have a market presence.*

A second factor concerns whether the likely entry candidates face high or low entry barriers. High barriers reduce the competitive threat of potential entry, while low barriers make entry more likely, especially if the industry is growing and offers attractive profit opportunities. The most widely encountered barriers that entry candidates must hurdle include:[7]

- *The presence of sizable economies of scale in production or other areas of operation*—When incumbent companies enjoy cost advantages associated with large-scale operations, outsiders must either enter on a large scale (a costly and perhaps risky move) or accept a cost disadvantage and consequently lower profitability.
- *Cost and resource disadvantages not related to scale of operation*—Aside from enjoying economies of scale, industry incumbents can have cost advantages that stem from experience/learning curve effects, the possession of proprietary technology, partnerships with the best and cheapest suppliers, and low fixed costs (because they have older facilities that have been mostlyde preciated).
- *Strong brand preferences and high degrees of customer loyalty*—The stronger the attachment of buyers to established brands, the harder it is for a newcomer to break into the marketplace.
- *High capital requirements*—The larger the total dollar investment needed to enter the market successfully, the more limited the pool of potential entrants. The most obvious capital requirements for new entrants relate to manufacturing facilities and equipment, introductory advertising and sales promotion campaigns, working capital to finance inventories and customer credit, and sufficient cash to cover start-up costs.
- *The difficulties of building a network of distributors-retailers and securing adequate space on retailers' shelves*—A potential entrant can face numerous distribution channel challenges. Wholesale distributors may be reluctant to take on a product that lacks buyer recognition. Retailers have to be recruited and convinced to give a new brand ample display space and an adequate trial period. Potential entrants sometimes have to "buy" their way into wholesale or retail channels by cutting their prices to provide dealers and distributors with higher markups and profit margins or by giving them big advertising and promotional allowances.
- *Restrictive regulatory policies*—Government agencies can limit or even bar entry by requiring licenses and permits. Regulated industries like cable TV, telecommunications, electric and gas utilities, and radio and television broadcasting entail government-controlled entry.

[7] The role of entry barriers in shaping the strength of competition in a particular market has long been a standard topic in the literature of microeconomics. For a discussion of how entry barriers affect competitive pressures associated with potential entry, see J. S. Bain, *Barriers to New Competition* (Cambridge, MA: Harvard University Press, 1956); F. M. Scherer, *Industrial Market Structure and Economic Performance* (Chicago: Rand McNally & Co., 1971), pp. 216–220, 226–233; Porter, *Competitive Strategy*, pp. 7–17; and Porter, "The Five Competitive Forces That Shape Strategy," pp. 80–82.

- *Tariffs and international trade restrictions*—National governments commonly use tariffs and trade restrictions (antidumping rules, local content requirements, local ownership requirements, quotas, etc.) to raise entry barriers for foreign firms and protect domestic producers from outside competition.
- *The ability and willingness of industry incumbents to launch vigorous initiatives to block a newcomer's successful entry*—Even if a potential entrant has or can acquire the needed competencies and resources to attempt entry, it must still worry about the reaction of existing firms.[8] Sometimes, there's little that incumbents can do to throw obstacles in an entrant's path. But there are times when incumbents use price cuts, increase advertising, introduce product improvements, and launch legal attacks to prevent the entrant from building a clientele. Cable TV companies have vigorously fought the entry of satellite TV into the industry by seeking government intervention to delay satellite providers in offering local stations, offering satellite customers discounts to switch back to cable, and charging satellite customers high monthly rates for cable Internet access.

In evaluating the overall effect of barriers to entry in preventing newcomers from entering the industry, company managers must also look at how attractive the growth and profit prospects are for new entrants. *Rapidly growing market demand and high potential profits act as magnets, motivating potential entrants to commit the resources needed to hurdle entry barriers.*[9] When profits are sufficiently attractive, entry barriers are unlikely to be an effective entry deterrent. Hence, *the best test of whether potential entry is a strong or weak competitive force in the marketplace is to ask if the industry's growth and profit prospects are strongly attractive to potential entry candidates.*

Figure 3.6 summarizes conditions making the threat of entry strong or weak.

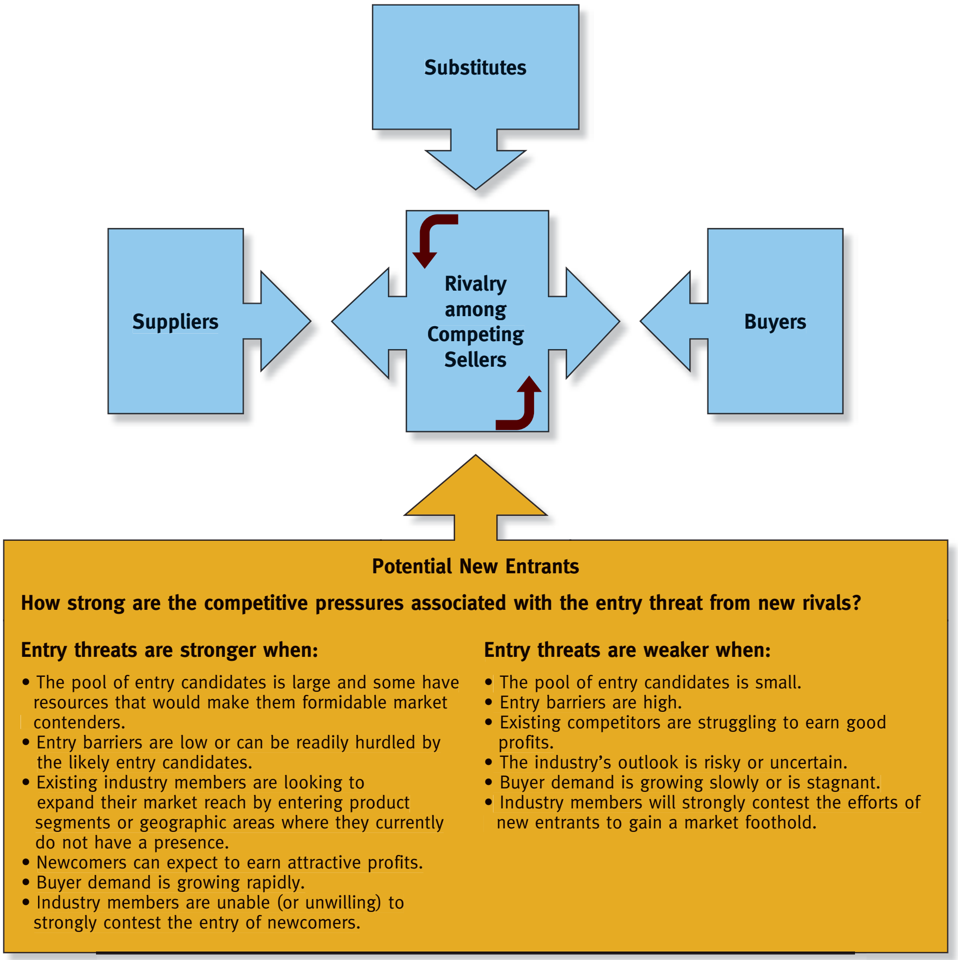
The Competitive Force of Rivalry among Competing Sellers

The strongest of the five competitive forces is nearly always the rivalry among competing sellers of a product or service. In effect, *a market is a competitive battlefield* where there's no end to the campaign for buyer patronage. Rival sellers are prone to employ whatever weapons they have in their business arsenal to improve their market positions, strengthen their market position with buyers, and earn good profits. The strategy-making challenge is to craft a competitive strategy that, at the very least, allows a company to hold its own against rivals and that, ideally, *produces a competitive edge over rivals.* But competitive contests are ongoing and dynamic. When one firm makes a strategic move that produces good results, its rivals typically respond with offensive or defensive countermoves of their own. This pattern of action and reaction produces a continually evolving competitive landscape where the market battle ebbs and flows and produces winners and losers. But the current market leaders have no guarantees of continued leadership. In every industry, the ongoing

[8] Porter, "How Competitive Forces Shape Strategy, p. 140; Porter, *Competitive Strategy*, pp. 14–15; and Porter, "The Five Competitive Forces That Shape Strategy," p. 82.

[9] For a good discussion of this point, see George S. Yip, "Gateways to Entry," *Harvard Business Review* 60, no. 5 (September–October 1982), pp. 85–93.

FIGURE 3.6 **Factors Affecting the Threat of Entry**



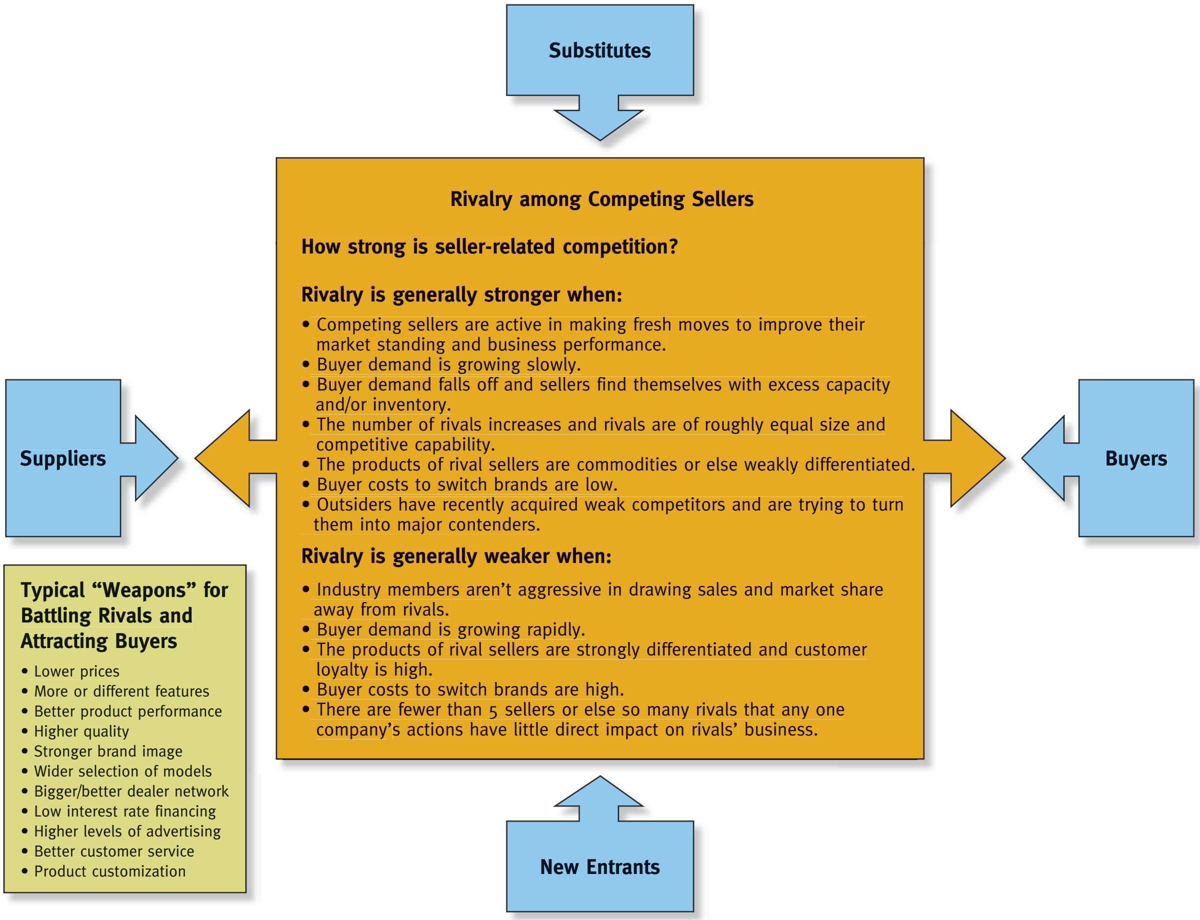
jockeying of rivals leads to one or another companies gaining or losing momentum in the marketplace according to whether their latest strategic maneuvers succeed or fail.[10]

Figure3.7 shows a sampling of competitive weapons that firms can deploy in battling rivals and indicates the factors that influence the intensity of their rivalry. Some of the factors that influence the tempo of rivalry among industry competitorsi nclude:[11]

- *Rivalry intensifies when competing sellers regularly launch fresh actions to boost their market standing and business performance.* Normally, competitive jockeying among rival sellers is fairly intense. Indicators of strong competitive

[10] The tendency of firms to counter competitive moves of rival firms can cause escalating competitive pressures that affect the profitability of rivals; see Pamela J. Derfus, Patrick G. Maggitti, Curtis M. Grimm, and Ken G. Smith, "The Red Queen Effect: Competitive Actions and Firm Performance," *Academy of Management Journal* 51, no. 1 (February 2008), pp. 61–80.
[11] Many of these indicators of whether rivalry produces intense competitive pressures are based on Porter, *Competitive Strategy,* pp. 17–21; and Porter, "The Five Competitive Forces That Shape Strategy," pp. 85–86.

FIGURE 3.7 **Factors Affecting the Strength of Competitive Rivalry**



rivalry include lively price competition, the rapid introduction of next-generation products, and moves to differentiate products by offering better performance features, higher quality, improved customer service, or a wider product selection. Other common tactics used to temporarily boost sales include special sales promotions, heavy advertising, rebates, or low-interest-rate financing.

- *Rivalry is stronger in industries where competitors are equal in size and capability.* Competitive rivalry in the quick-service restaurant industry is particularly strong, where there are numerous relatively equal-sized hamburger, deli sandwich, chicken, and taco chains. For the most part, McDonald's, Burger King, Taco Bell, KFC, Arby's, and other national fast food chains have comparable capabilities and are required to compete aggressively to hold their own in the industry.
- *Rivalry is usually stronger in slow-growing markets and weaker in fast-growing markets.* Rapidly expanding buyer demand produces enough new business for all industry members to grow. But in markets where growth is sluggish or where buyer demand drops off unexpectedly, it is not uncommon

for competitive rivalry to intensify significantly as rivals battle for market share and volume gains.

- *Rivalry is usually weaker in industries comprised of vast numbers of small rivals; likewise, it is often weak when there are fewer than five competitors.* Head-to-head rivalry tends to be weak once an industry becomes populated with so many rivals that the strategic moves of any one competitor have little discernible impact on the success of rivals. Rivalry also *tends* to be weak if an industry consists of just two to four sellers. In a market with few rivals, each competitor soon learns that aggressive moves to grow its sales and market share can have an immediate adverse impact on rivals' businesses, almost certainly provoking vigorous retaliation. However, some caution must be exercised in concluding that rivalry is weak just because there are only a few competitors. The fierceness of the current battle between Linux and Microsoft and the decades-long war between Coca-Cola and Pepsi are prime examples.
- *Rivalry increases when buyer demand falls off and sellers find themselves with excess capacity and/or inventory.* Excess supply conditions create a "buyers' market," putting added competitive pressure on industry rivals to scramble for profitable sales levels (often by price discounting).
- *Rivalry increases as it becomes less costly for buyers to switch brands.* The less expensive it is for buyers to switch their purchases from the seller of one brand to the seller of another brand, the easier it is for sellers to steal customers away from rivals.
- *Rivalry increases as the products of rival sellers become more standardized and diminishes as the products of industry rivals become more differentiated.* When the offerings of rivals are identical or weakly differentiated, buyers have less reason to be brand loyal—a condition which makes it easier for rivals to convince buyers to switch to their offering. On the other hand, strongly differentiated product offerings among rivals breed high brand loyalty on the part of buyers.
- *Rivalry is more intense when industry conditions tempt competitors to use price cuts or other competitive weapons to boost unit volume.* When a product is perishable, seasonal, or costly to hold in inventory, competitive pressures build quickly any time one or more firms decide to cut prices and dump supplies on the market. Likewise, whenever fixed costs account for a large fraction of total cost, so that unit costs tend to be lowest at or near full capacity, firms come under significant pressure to cut prices or otherwise try to boost sales whenever they are operating below full capacity.
- *Rivalry increases when one or more competitors become dissatisfied with their market position.* Firms that are losing ground or are in financial trouble often pursue aggressive (or perhaps desperate) turnaround strategies that can involve price discounts, greater advertising, or merger with other rivals. Such strategies can turn competitive pressures up a notch.
- *Rivalry increases when strong companies outside the industry acquire weak firms in the industry and launch aggressive, well-funded moves to build market share.* A concerted effort to turn a weak rival into a market leader nearly always entails launching well-financed strategic initiatives to dramatically

improve the competitor's product offering, excite buyer interest, and win a much bigger market share—actions that, if successful, put added pressure on rivals to counter with fresh strategic moves of their own.

Rivalry can be characterized as *cutthroat* or *brutal* when competitors engage in protracted price wars or habitually employ other aggressive tactics that are mutually destructive to profitability. Rivalry can be considered *fierce* to *strong* when the battle for market share is so vigorous that the profit margins of most industry members are squeezed to bare-bones levels. Rivalry can be characterized as *moderate* or *normal* when the maneuvering among industry members, while lively and healthy, still allows most industry members to earn acceptable profits. Rivalry is *weak* when most companies in the industry are relatively well satisfied with their sales growth and market share and rarely undertake offensives to steal customers away from one another.

The Collective Strengths of the Five Competitive Forces and Industry Profitability

Scrutinizing each of the five competitive forces one by one provides a powerful diagnosis of what competition is like in a given market. Once the strategist has gained an understanding of the competitive pressures associated with each of the five forces, the next step is to evaluate the collective strength of the five forces and determine if companies in this industry should reasonably expect to earn decent profits.

As a rule, the stronger the collective impact of the five competitive forces, the lower the combined profitability of industry participants. The most extreme case of a "competitively unattractive" industry is when all five forces are producing strong competitive pressures: Rivalry among sellers is vigorous, low entry barriers allow new rivals to gain a market foothold, competition from substitutes is intense, and both suppliers and customers are able to exercise considerable bargaining leverage. Fierce to strong competitive pressures coming from all five directions nearly always drive industry profitability to unacceptably low levels, frequently producing losses for many industry members and forcing some out of business. But an industry can be competitively unattractive without all five competitive forces being strong. Intense competitive pressures from just two or three of the five forces may suffice to destroy the conditions for good profitability. Unattractive competitive conditions that include strong substitutes, fierce competitive rivalry, and low buyer switching costs, for example, have created a dismal outlook for the video rental business. In 2008, Blockbuster recorded a net loss of $374 million on revenues of $5.3 billion, while industry runner-up, Movie Gallery, entered into bankruptcy in October 2007 after recording losses for three consecutive years. Movie Gallery lost an additional $70 million by the end of 2007 and its shares were delisted by NASDAQ in 2008.

The stronger the forces of competition, the harder it becomes for industry members to earn attractive profits.

In contrast, when the collective impact of the five competitive forces is moderate to weak, an industry is competitively attractive in the sense that industry members can reasonably expect to earn good profits and a nice return on investment. The ideal competitive environment for earning superior profits is one in which both suppliers and customers are in weak bargaining positions, there are no good substitutes, high barriers block further entry, and rivalry among present sellers generates only moderate competitive pressures. Weak competition is the best of all possible worlds for companies with mediocre strategies and second-rate implementation because even they can expect a decent profit.

Question 3: What Are the Industry's Driving Forces of Change and What Impact Will They Have?

The intensity of competitive forces and the level of industry attractiveness are almost always fluid and subject to change. It is essential for strategy makers to understand the current competitive dynamics of the industry, but it is equally important for strategy makers to consider how the industry is changing and the effect of industry changes that are under way. Any strategies devised by management will play out in a dynamic industry environment, so it's imperative that such plans consider what the industry environment might look like during the near term.

The Concept of Industry Driving Forces

Industry and competitive conditions change because forces are enticing or pressuring certain industry participants (competitors, customers, suppliers) to alter their actions in important ways.[12] The most powerful of the change agents are called **driving forces** because they have the biggest influences in reshaping the industry landscape and altering competitive conditions. Some driving forces originate in the outer ring of the company's macro-environment (see Figure 3.1) but most originate in the company's more immediate industry and competitive environment.

Driving forces are the major underlying causes of change in industry and competitive conditions.

Driving forces analysis has three steps: (1) identifying what the driving forces are, (2) assessing whether the drivers of change are, individually or collectively, acting to make the industry more or less attractive, and (3) determining what strategy changes are needed to prepare for the impact of the driving forces.

Identifying an Industry's Driving Forces

Many developments can affect an industry powerfully enough to qualify as driving forces, but most drivers of industry and competitive change fall into one of the following categories:[13]

- *Changes in an industry's long-term growth rate*—Shifts in industry growth have the potential to affect the balance between industry supply and buyer

[12] Porter, *Competitive Strategy*, p. 162.

[13] Most of the driving forces described here are based on the discussion in Porter, *Competitive Strategy*, pp. 164–183.

demand, entry and exit, and the character and strength of competition. An upsurge in buyer demand triggers a race among established firms and newcomers to capture the new sales opportunities. A slowdown in the growth of demand nearly always brings an increase in rivalry and increased efforts by some firms to maintain their high rates of growth by taking sales and market share away from rivals.

- *Increasing globalization*—Competition begins to shift from primarily a regional or national focus to an international or global focus when industry members begin seeking out customers in foreign markets or when production activities begin to migrate to countries where costs are lowest. The forces of globalization are sometimes such a strong driver that companies find it highly advantageous, if not necessary, to spread their operating reach into more and more country markets. Globalization is very much a driver of industry change in such industries as credit cards, mobile phones, digital cameras, golf and ski equipment, motor vehicles, steel, petroleum, personal computers, and videogames.
- *Emerging new Internet capabilities and applications*—Mushrooming Internet use and an ever growing series of Internet applications and capabilities have been major drivers of change in industry after industry. The ability of companies to reach consumers via the Internet increases the number of rivals a company faces and often escalates rivalry by pitting pure online sellers against local brick-and-mortar sellers. The Internet gives buyers unprecedented ability to research the product offerings of competitors and shop the market for the best value. Widespread use of e-mail has forever eroded the business of providing fax services and the first-class mail delivery revenues of governmental postal services worldwide. Video-conferencing via the Internet erodes the demand for business travel. Online course offerings are profoundly affecting higher education. The Internet of the future will feature faster speeds, dazzling applications, and over a billion connected gadgets performing an array of functions, thus driving further industry and competitive changes. But Internet-related impacts vary from industry to industry. The challenges here are to assess precisely how emerging Internet developments are altering a particular industry's landscape and to factor these impacts into the strategy-making equation.
- *Changes in who buys the product and how they use it*—Shifts in buyer demographics and the ways products are used can alter competition by affecting how customers perceive value, how customers make purchasing decisions, and where customers purchase the product. The burgeoning popularity of downloading music from the Internet has significantly changed the recording industry. Consumers often consider format compatibility with iPods, MP3 players, or mobile phones, and may acquire the track either legally through an online store or illegally through a file sharing network. According to Nielsen SoundScan, album sales have declined from 785.1 million units in 2000 to 428 million units in 2008. The changing nature of consumer music purchases led to digital single sales by Web sites such as iTunes Store, Rhapsody, Napster, and Walmart.com to exceed 1 billion in 2008.

- *Product innovation*—An ongoing stream of product innovations tends to alter the pattern of competition in an industry by attracting more first-time buyers, rejuvenating industry growth, and/or creating wider or narrower product differentiation among rival sellers. Product innovation has been a key driving force in such industries as computers, digital cameras, televisions, video games, and prescription drugs.
- *Technological change and manufacturing process innovation*—Advances in technology can dramatically alter an industry's landscape, making it possible to produce new and better products at lower cost and opening up whole new industry frontiers. For instance, Voice over Internet Protocol technology (VoIP) has spawned low-cost, Internet-based phone networks that have begun competing with traditional telephone companies worldwide (whose higher cost technology depends on hard-wire connections via overhead and underground telephone lines).
- *Marketing innovation*—When firms are successful in introducing *new ways* to market their products, they can spark a burst of buyer interest, widen industry demand, increase product differentiation, and lower unit costs—any or all of which can alter the competitive positions of rival firms and force strategy revisions.
- *Entry or exit of major firms*—The entry of one or more foreign companies into a geographic market once dominated by domestic firms nearly always shakes up competitive conditions. Likewise, when an established domestic firm from another industry attempts entry either by acquisition or by launching its own start-up venture, it usually pushes competition in newd irections.
- *Diffusion of technical know-how across more companies and more countries*—As knowledge about how to perform a particular activity or execute a particular manufacturing technology spreads, the competitive advantage held by firms originally possessing this know-how erodes. Knowledge diffusion can occur through scientific journals, trade publications, onsite plant tours, word of mouth among suppliers and customers, employee migration, and Internet sources.
- *Changes in cost and efficiency*—Widening or shrinking differences in the costs among key competitors tend to dramatically alter the state of competition. Declining costs to produce PCs have enabled price cuts and spurred PC sales (especially lower-priced models) by making them more affordable to lower income households worldwide.
- *Growing buyer preferences for differentiated products instead of a commodity product (or for a more standardized product instead of strongly differentiated products)*—When a shift from standardized to differentiated products occurs, rivals must adopt strategies to outdifferentiate one another. However, buyers sometimes decide that a standardized, budget-priced product suits their requirements as well as a premium-priced product with lots of snappy features and personalized services.
- *Regulatory influences and government policy changes*—Government regulatory actions can often force significant changes in industry practices and

strategic approaches. Passage of the "Do Not Call Registry" in 2003 has made it difficult for many businesses relying on telemarketing-based sales approaches to generate new customers. For example, Scholastic, Inc., the world's largest publisher and distributor of children's books (including *Harry Potter* and *The Baby-Sitters Club*), announced in 2008 that it would divest its direct-to-home book club business unit because of challenges created by the "Do Not Call" legislation. Scholastic's book-club division had for years relied on telemarketing to sign up new book club members. (Note that this driving force is spawned by forces in a company's macroenvironment.)

- *Changing societal concerns, attitudes, and lifestyles*—Emerging social issues and changing attitudes and lifestyles can be powerful instigators of industry change. Consumer concerns about salt, sugar, chemical additives, saturated fat, cholesterol, carbohydrates, and nutritional value have forced food producers to revamp food-processing techniques, redirect R&D efforts into the use of healthier ingredients, and compete in developing nutritious, good-tasting products.

While many forces of change may be at work in a given industry, *no more than three or four* are likely to be true driving forces powerful enough to qualify as the *major determinants* of why and how the industry is changing. Thus company strategists must resist the temptation to label every change they see as a driving force. Table 3.2 lists the most common driving forces.

Assessing the Impact of the Industry Driving Forces

The second step in driving forces analysis is to determine whether the prevailing driving forces are acting to make the industry environment more or

Table 3.2

Common Driving Forces

1. Changes in the long-term industry growth rate.
2. Increasing globalization.
3. Emerging new Internet capabilities and applications.
4. Changes in who buys the product and how they use it.
5. Product innovation.
6. Technological change and manufacturing process innovation.
7. Marketing innovation.
8. Entry or exit of major firms.
9. Diffusion of technical know-how across more companies and more countries.
10. Changes in cost and efficiency.
11. Growing buyer preferences for differentiated products instead of a standardized commodity product (or for a more standardized product instead of strongly differentiated products).
12. Regulatory influences and government policy changes.
13. Changing societal concerns, attitudes, and lifestyles.

less attractive. Getting a handle on the collective impact of the driving forces usually requires looking at the likely effects of each force separately, because the driving forces may not all be pushing change in the same direction. For example, two driving forces may be acting to spur demand for the industry's product while one driving force may be working to curtail demand. Whether the net effect on industry demand is up or down hinges on which driving forces are the more powerful.

An important part of driving forces analysis is to determine whether the individual or collective impact of the driving forces will be to increase or decrease market demand, make competition more or less intense, and lead to higher or lower industry profitability.

Determining Strategy Changes Needed to Prepare for the Impact of Driving Forces

The third step of driving forces analysis—where the real payoff for strategy making comes—is for managers to draw some conclusions about what strategy adjustments will be needed to deal with the impact of the driving forces. Without understanding the forces driving industry change and the impacts these forces will have on the industry environment over the next one to three years, managers are ill prepared to craft a strategy tightly matched to emerging conditions. Similarly, if managers are uncertain about the implications of one or more driving forces, or if their views are off-base, it will be difficult for them to craft a strategy that is responsive to the consequences of driving forces. So driving forces analysis is not something to take lightly; it has practical value and is basic to the task of thinking strategically about where the industry is headed and how to prepare for the changes ahead.

The real payoff of driving forces analysis is to help managers understand what strategy changes are needed to prepare for the impacts of the driving forces.

Question 4: How Are Industry Rivals Positioned?

The nature of competitive strategy inherently positions companies competing in an industry into strategic groups with diverse price/quality ranges, different distribution channels, varying product features, and different geographic coverages. The best technique for revealing the market positions of industry competitors is **strategic group mapping.**[14] This analytical tool is useful for comparing the market positions of industry competitors or for grouping industry combatants into like positions.

Using Strategic Group Maps to Assess the Positioning of Key Competitors

A **strategic group** consists of those industry members with similar competitive approaches and positions in the market.[15] Companies in the same strategic group can resemble one another in any of several ways—they may have comparable product-line breadth, sell in the same price/quality range, emphasize the same distribution channels, use essentially the same product attributes to appeal to similar types of buyers,

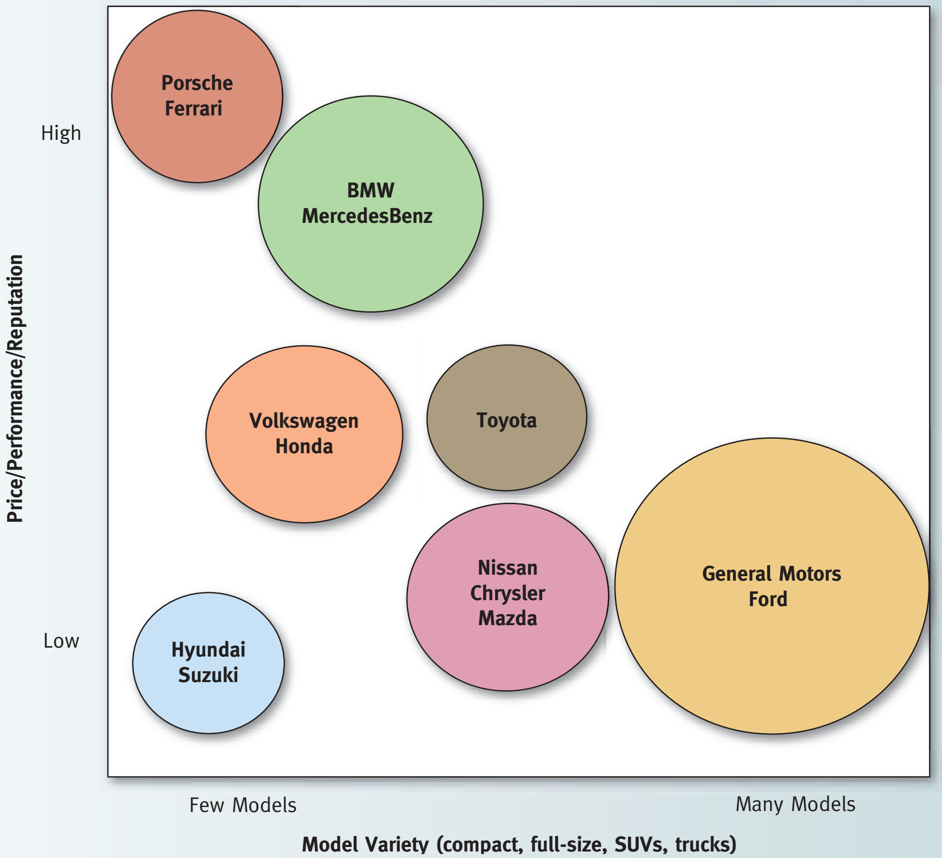
A strategic group is a cluster of industry rivals that have similar competitive approaches and market positions.

[14] Porter, *Competitive Strategy*, chapter 7.

[15] Ibid., pp. 129–30.

Concepts & Connections 3.1

COMPARATIVE MARKET POSITIONS OF SELECTED AUTOMOBILE MANUFACTURERS: A STRATEGIC GROUP MAP APPLICATION



Note: Circles are drawn roughly proportional to the total revenues of manufacturers included in each strategic group.

depend on identical technological approaches, or offer buyers similar services and technical assistance.[16] An industry with a commoditylike product may contain only one strategic group whereby all sellers pursue essentially identical strategies and have comparable market positions. But even with commodity products, there is likely some attempt at differentiation taking place in the form of varying delivery times, financing terms, or levels of customer service. Most industries offer a host of competitive approaches that allow companies to find unique industry positioning and avoid fierce competition in a crowded strategic group. Evaluating strategy options entails examining what strategic groups

[16] For an excellent discussion of how to identify the factors that define strategic groups, see Mary Ellen Gordon and George R. Milne, "Selecting the Dimensions That Define Strategic Groups: A Novel Market-Driven Approach," *Journal of Managerial Issues* 11, no. 2 (Summer 1999), pp. 213–233.

exist, identifying which companies exist within each group, and determining if a competitive "white space" exists where industry competitors are able to create and capture altogether new demand.

The procedure for constructing a *strategic group map* is straightforward:

- Identify the competitive characteristics that delineate strategic approaches used in the industry. Typical variables used in creating strategic group maps are the price/quality range (high, medium, low), geographic coverage (local, regional, national, global), degree of vertical integration (none, partial, full), product-line breadth (wide, narrow), choice of distribution channels (retail, wholesale, Internet, multiple channels), and degree of service offered (no-frills, limited, full).
- Plot firms on a two-variable map based upon their strategic approaches.
- Assign firms occupying the same map location to a common strategic group.
- Draw circles around each strategic group, making the circles proportional to the size of the group's share of total industry sales revenues.

This produces a two-dimensional diagram like the one for the world automobile industry in Concepts & Connections 3.1.

Several guidelines need to be observed in creating strategic group maps.[17] First, the two variables selected as axes for the map should *not* be highly correlated; if they are, the circles on the map will fall along a diagonal and strategy makers will learn nothing more about the relative positions of competitors than they would by considering just one of the variables. For instance, if companies with broad product lines use multiple distribution channels while companies with narrow lines use a single distribution channel, then looking at product line breadth reveals just as much about industry positioning as looking at the two competitive variables. Second, the variables chosen as axes for the map should reflect key approaches to offering value to customers and expose big differences in how rivals position themselves in the marketplace. Third, the variables used as axes don't have to be either quantitative or continuous; rather, they can be discrete variables or defined in terms of distinct classes and combinations. Fourth, drawing the sizes of the circles on the map proportional to the combined sales of the firms in each strategic group allows the map to reflect the relative sizes of each strategic group. Fifth, if more than two good competitive variables can be used as axes for the map, multiple maps can be drawn to give different exposures to the competitive positioning in the industry. Because there is not necessarily one best map for portraying how competing firms are positioned in the market, it is advisable to experiment with different pairs of competitive variables.

The Value of Strategic Group Maps

Strategic group maps are revealing in several respects. The *most important* has to do with identifying which rivals are similarly positioned and are thus

[17] Porter, *Competitive Strategy*, pp. 152–154.

close rivals and which are distant rivals. Generally speaking, *the closer strategic groups are to each other on the map, the stronger the cross-group competitive rivalry tends to be.* Although firms in the same strategic group are the closest rivals, the next closest rivals are in the immediately adjacent groups.[18] Often, firms in strategic groups that are far apart on the map hardly compete at all. For instance, Walmart's clientele, merchandise selection, and pricing points are much too different to justify calling them close competitors of Neiman Marcus or Saks Fifth Avenue in retailing. For the same reason, Timex is not a meaningful competitive rival of Rolex, and Kia is not a close competitor of Porsche or Lexus.

The second thing to be gleaned from strategic group mapping is that *not all positions on the map are equally attractive.* Two reasons account for why some positions can be more attractive than others:

1. *Industry driving forces may favor some strategic groups and hurt others.*[19] Driving forces in an industry may be acting to grow the demand for the products of firms in some strategic groups and shrink the demand for the products of firms in other strategic groups—as is the case in the news industry where Internet news services and cable news networks are gaining ground at the expense of newspapers and network television. The industry driving forces of emerging Internet capabilities and applications, changes in who buys the product and how they use it, and changing societal concerns, attitudes, and lifestyles are making it increasingly difficult for traditional media to increase audiences and attract new advertisers.
2. *Competitive pressures may cause the profit potential of different strategic groups to vary.* The profit prospects of firms in different strategic groups can vary from good to poor because of differing degrees of competitive rivalry within strategic groups, differing degrees of exposure to competition from substitute products outside the industry, and differing degrees of supplier or customer bargaining power from group to group. For instance, the competitive battle between Walmart and Target is more intense (with consequently smaller profit margins) than the rivalry among Versace, Chanel, Fendi, and other high-end fashion retailers.

Thus, part of strategic group analysis always entails drawing conclusions about where on the map is the "best" place to be and why. Which companies or strategic groups are in the best positions to prosper and which might be expected to struggle? And equally important, how might firms in poorly positioned strategic groups reposition themselves to improve their prospects for good financial performance?

[18] Strategic groups act as good reference points for predicting the evolution of an industry's competitive structure. See Avi Fiegenbaum and Howard Thomas, "Strategic Groups as Reference Groups: Theory, Modeling and Empirical Examination of Industry and Competitive Strategy," *Strategic Management Journal* 16 (1995), pp. 461–476. For a study of how strategic group analysis helps identify the variables that lead to sustainable competitive advantage, see S. Ade Olusoga, Michael P. Mokwa, and Charles H. Noble, "Strategic Groups, Mobility Barriers, and Competitive Advantage," *Journal of Business Research* 33 (1995), pp. 153–164.

[19] Ibid., Porter, *Competitive Strategy*, pp. 130,132–138, and 154–155.

Question 5: What Strategic Moves Are Rivals Likely to Make Next?

As in sports, scouting the business opposition is an essential part of game plan development. **Competitive intelligence** about rivals' strategies, their latest actions and announcements, their resource strengths and weaknesses, and the thinking and leadership styles of their executives is valuable for predicting the strategic moves competitors are likely to make next. Having good information to predict the likely moves of key competitors allows a company to prepare defensive countermoves and to exploit any openings that arise from competitors'mi ssteps.

Predicting the Moves of Industry Rivals

Considerations in trying to predict what strategic moves rivals are likely to make next include the following:

- What executives are saying about where the industry is headed, the firm's situation, and their past actions and leadership styles.
- Identifying trends in the timing of new product launches or marketing promotions.
- Determining which rivals badly need to increase unit sales and market share.
- Considering which rivals have a strong incentive, along with the resources, to make major strategic changes.
- Knowing which rivals are likely to enter new geographic markets.
- Deciding which rivals are strong candidates to expand their product offerings and enter new product segments.

Studying competitors' past behavior and preferences provides a valuable assist in anticipating what moves rivals are likely to make next and outmaneuvering them in the marketplace.

To succeed in predicting a competitor's next moves, company strategists need to have a good understanding of each rival's situation, its pattern of behavior and preferences in responding to prior strategic attacks, what its best strategic options are, and how rival management measures success. Doing the necessary detective work can be tedious and time-consuming, but scouting competitors well enough to anticipate their next moves allows managers to prepare effective countermoves and to take rivals' probable actions into account in crafting their own offensive strategies.[20]

BUSINESS ETHICS AND COMPETITIVE INTELLIGENCE Those who gather competitive intelligence on rivals, however, can sometimes cross the fine line between honest inquiry and unethical or even illegal behavior. For example, calling rivals to get information about prices, the dates of new

[20] For an excellent discussion of an effective methodology that may be used to predict rivals' next moves, see Kevin P. Coyne and John Horn, "Predicting Your Competitor's Reaction," *Harvard Business Review* 87, no. 4 (April 2009), pp. 90–97.

product introductions, or wage and salary levels is legal, but misrepresenting one's company affiliation during such calls is unethical. Pumping rivals' representatives at trade shows is ethical only if one wears a name tag with accurate company affiliation indicated. Avon Products at one point secured information about its biggest rival, Mary Kay Cosmetics (MKC), by having its personnel search through the garbage bins outside MKC's headquarters.[21] When MKC officials learned of the action and sued, Avon claimed it did nothing illegal, since a 1988 Supreme Court case had ruled that trash left on public property (in this case, a sidewalk) was anyone's for the taking. Avon even produced a videotape of its removal of the trash at the MKC site. Avon won the lawsuit—but Avon's action, while legal, scarcely qualifies as ethical.

Question 6: What Are the Industry Key Success Factors?

An industry's **key success factors (KSFs)** are those competitive factors that most affect industry members' ability to prosper in the marketplace. Key success factors may include particular strategy elements, product attributes, resources, competitive capabilities, or intangible assets. KSFs by their very nature are so important to future competitive success that *all firms* in the industry must pay close attention to them or risk an eventual exit from the industry.

Key success factors are the strategy elements, product attributes, competitive capabilities, or intangible assets with the greatest impact on future success in the marketplace.

In the ready-to-wear apparel industry, the KSFs are appealing designs and color combinations, low-cost manufacturing, a strong network of retailers or company-owned stores, distribution capabilities that allow stores to keep the best-selling items in stock, and advertisements that effectively convey the brand's image. These attributes and capabilities apply to all brands of apparel ranging from private-label brands sold by discounters to premium-priced ready-to-wear brands sold by upscale department stores. Table 3.3 lists the most common types of industry key success factors.

An industry's key success factors can usually be deduced through identifying the industry's dominant characteristics, assessing the five competitive forces, considering the impacts of the driving forces, comparing the market positions of industry members, and forecasting the likely next moves of key rivals. In addition, the answers to the following three questions help identify an industry's key success factors:

1. On what basis do buyers of the industry's product choose between the competing brands of sellers? That is, what product attributes are crucial?
2. Given the nature of the competitive forces prevailing in the marketplace, what resources and competitive capabilities does a company need to have to be competitively successful?

[21] Larry Kahaner, *Competitive Intelligence* (New York: Simon and Schuster, 1996), pp. 84–85.

Table 3.3

Common Types of Industry Key Success Factors

Technology-related KSFs	• Expertise in a particular technology or in scientific research (important in pharmaceuticals, Internet applications, mobile communications, and most "high-tech" industries) • Proven ability to improve production processes (important in industries where advancing technology opens the way for higher manufacturing efficiency and lower production costs)
Manufacturing-related KSFs	• Ability to achieve scale economies and/or capture experience curve effects (important to achieving low production costs) • Quality control know-how (important in industries where customers insist on product reliability) • High utilization of fixed assets (important in capital-intensive/high-fixed-cost industries) • Access to attractive supplies of skilled labor • High labor productivity (important for items with high labor content) • Low-cost product design and engineering (reduces manufacturing costs) • Ability to manufacture or assemble products that are customized to buyer specifications
Distribution-related KSFs	• A strong network of wholesale distributors/dealers • Strong direct sales capabilities via the Internet and/or having company owned retail outlets • Ability to secure favorable display space on retailer shelves
Marketing-related KSFs	• Breadth of product line and product selection • A well-known and well-respected brand name • Fast, accurate technical assistance • Courteous, personalized customer service • Accurate filling of buyer orders (few back orders or mistakes) • Customer guarantees and warranties (important in mail-order and online retailing, big-ticket purchases, and new product introductions) • Clever advertising
Skills- and capability-related KSFs	• A talented workforce (superior talent is important in professional services like accounting and investment banking) • National or global distribution capabilities • Product innovation capabilities (important in industries where rivals are racing to be first-to-market with new product attributes or performance features) • Design expertise (important in fashion and apparel industries) • Short delivery time capability • Supply chain management capabilities • Strong e-commerce capabilities—a user-friendly Web site and/or skills in using Internet technology applications to streamline internal operations
Other types of KSFs	• Overall low costs (not just in manufacturing) to be able to meet low price expectations of customers • Convenient locations (important in many retailing businesses) • Ability to provide fast, convenient, after-the-sale repairs and service • A strong balance sheet and access to financial capital (important in newly emerging industries with high degrees of business risk and in capital-intensive industries) • Patent protection

3. What shortcomings are almost certain to put a company at a significant competitive disadvantage?

Only rarely are there more than five or six key factors for future competitive success. Managers should therefore resist the temptation to label a factor that has only minor importance a KSF. To compile a list of every factor that matters even a little bit defeats the purpose of concentrating management attention on the factors truly critical to long-term competitive success.

Question 7: Does the Industry Offer Good Prospects for Attractive Profits?

The final step in evaluating the industry and competitive environment is boiling down the results of the analyses performed in Questions 1–6 to determine if the industry offers a company strong prospects for attractive profits.

The important factors on which to base such a conclusion include:

- The industry's growth potential.
- Whether powerful competitive forces are squeezing industry profitability to subpar levels and whether competition appears destined to grow stronger or weaker.
- Whether industry profitability will be favorably or unfavorably affected by the prevailing driving forces.
- The company's competitive position in the industry vis-à-vis rivals. (Well-entrenched leaders or strongly positioned contenders have a much better chance of earning attractive margins than those fighting a steep uphill battle.)
- How competently the company performs industry key success factors.

It is a mistake to think of a particular industry as being equally attractive or unattractive to all industry participants and all potential entrants. Conclusions have to be drawn from the perspective of a particular company. Industries attractive to insiders may be unattractive to outsiders. Industry environments unattractive to weak competitors may be attractive to strong competitors. A favorably positioned company may survey a business environment and see a host of opportunities that weak competitors cannot capture.

The degree to which an industry is attractive or unattractive is not the same for all industry participants and potential new entrants. The attractiveness of an industry depends on the degree of fit between a company's competitive capabilities and industry key success factors.

When a company decides an industry is fundamentally attractive, a strong case can be made that it should invest aggressively to capture the opportunities it sees. When a strong competitor concludes an industry is relatively unattractive, it may elect to simply protect its present position, investing cautiously if at all, and begin looking for opportunities in other industries. A competitively weak company in an unattractive industry may see its best option as finding a buyer, perhaps a rival, to acquire its business.

KeyP oints

Thinking strategically about a company's external situation involves probing for answers to the following seven questions:

1. *What are the industry's dominant economic features?* Industries differ significantly on such factors as market size and growth rate, the number and relative sizes of both buyers and sellers, the geographic scope of competitive rivalry, the degree of product differentiation, the speed of product innovation, demand-supply conditions, the extent of vertical integration, and the extent of scale economies and learning curve effects.
2. *What kinds of competitive forces are industry members facing, and how strong is each force?* The strength of competition is a composite of five forces: (1) competitive pressures stemming from buyer bargaining power and seller-buyer collaboration, (2) competitive pressures associated with the sellers of substitutes, (3) competitive pressures stemming from supplier bargaining power and supplier-seller collaboration, (4) competitive pressures associated with the threat of new entrants into the market, and (5) competitive pressures stemming from the competitive jockeying among industry rivals.
3. *What forces are driving changes in the industry, and what impact will these changes have on competitive intensity and industry profitability?* Industry and competitive conditions change because forces are in motion that create incentives or pressures for change. The first phase is to identify the forces that are driving industry change. The second phase of driving forces analysis is to determine whether the driving forces, taken together, are acting to make the industry environment more or less attractive.
4. *What market positions do industry rivals occupy—who is strongly positioned and who is not?* Strategic group mapping is a valuable tool for understanding the similarities and differences inherent in the market positions of rival companies. Rivals in the same or nearby strategic groups are close competitors, whereas companies in distant strategic groups usually pose little or no immediate threat. Some strategic groups are more favorable than others. The profit potential of different strategic groups may not be the same because industry driving forces and competitive forces likely have varying effects on the industry's distinct strategic groups.
5. *What strategic moves are rivals likely to make next?* Scouting competitors well enough to anticipate their actions can help a company prepare effective countermoves (perhaps even beating a rival to the punch) and allows managers to take rivals' probable actions into account in designing their own company's best course of action.
6. *What are the key factors for competitive success?* An industry's key success factors (KSFs) are the particular product attributes, competitive capabilities, and intangible assets that spell the difference between being a strong competitor and a weak competitor—and sometimes between profit and loss. KSFs by their very nature are so important to competitive success that *all firms* in the industry must pay close attention to them or risk being driven out of the industry.
7. *Does the outlook for the industry present the company with sufficiently attractive prospects for profitability?* Conclusions regarding industry attractiveness are a major driver of company strategy. When a company decides an industry is fundamentally attractive and presents good opportunities, a strong case can be made that it should invest aggressively to capture the opportunities it sees. When a strong competitor concludes an industry is relatively unattractive and lacking in opportunity, it may elect to simply protect its present position, investing cautiously if at all and looking for opportunities in other industries. A competitively weak

company in an unattractive industry may see its best option as finding a buyer, perhaps a rival, to acquire its business. On occasion, an industry that is unattractive overall is still very attractive to a favorably situated company with the skills and resources to take business away from weaker rivals.

Assurance of Learning Exercises

LO1 LO2 1. Prepare a brief analysis of the snack food industry using the information provided on industry trade association Web sites. Based upon information provided on the Web sites of these associations, draw a five-forces diagram for the snack food industry and briefly discuss the nature and strength of each of the five competitive forces. What driving forces of change are taking shape in the industry?

LO1 2. Based on the strategic group map in Concepts & Connections 3.1, who are Toyota's closest competitors? Between which two strategic groups is competition the strongest? Why do you think no automobile manufacturers are positioned in the upper right corner of the map? Which company/strategic group faces the weakest competition from the members of other strategic groups?

LO1 3. Usingt hei nformationp rovidedi n Table 3.3 and your knowledge as a casual dining patron, what are the key success factors for restaurants such as Outback Steakhouse or Carrabba's Italian Grill? Your list should contain no more than six industry key success factors. In deciding on your list, it's important to distinguish between factors critical to success in the industry and factors that enhance a company's overall well-being.

Exercises for Simulation Participants

LO1 LO2 LO3 1. Whicho ft hefi ve competitive forces is creating the strongest competitive pressures for your company?

2. What are the "weapons of competition" that rival companies in your industry can use to gain sales and market share? See Figure 3.7 to help you identify the various competitive factors.

3. What are the factors affecting the intensity of rivalry in the industry in which your company is competing? Use Figure 3.7 and the accompanying discussion to help you in pinpointing the specific factors most affecting competitive intensity. Would you characterize the rivalry and jockeying for better market position, increased sales, and market share among the companies in your industry as fierce, very strong, strong, moderate, or relatively weak? Why?

4. Are there any driving forces in the industry in which your company is competing? What impact will these driving forces have? Will they cause competition to be more or less intense? Will they act to boost or squeeze profit margins? List at least two actions your company should consider taking in order to combat any negative impacts of the driving forces.

5. Draw a strategic group map showing the market positions of the companies in your industry. Which companies do you believe are in the most attractive position on the map? Which companies are the most weakly positioned? Which companies do you believe are likely to try to move to a different position on the strategic group map?

6. What do you see as the key factors for being a successful competitor in your industry?Li stat l eastt hree.

Chapter 4

Internal Situation Analysis: Evaluating a Company's Resources, Cost Position, and Competitive Strength

Chapter Learning Objectives

LO1. Understand how to evaluate a company's internal situation, including its collection of competitively valuable resources and capabilities.

LO2. Grasp how and why activities performed internally by a company and those performed externally by its suppliers and forward channel allies determine a company's cost structure and ability to compete successfully.

LO3. Learn how to evaluate a company's competitive strength relative to key rivals.

LO4. Understand the role and importance of industry and competitive analysis and internal situation analysis in identifying strategic issues company managers must address.

In Chapter 3 we described how to use the tools of industry and competitive analysis to assess a company's external environment and lay the groundwork for matching a company's strategy to its external situation. In this chapter we discuss the techniques of evaluating a company's internal situation, including its collection of valuable resources and capabilities, its relative cost position, and its competitive strength versus its rivals. The analytical spotlight will be trained on five questions:

1. How well is the company's strategy working?
2. What are the company's competitively important resources and capabilities?
3. Are the company's prices and costs competitive?
4. Is the company competitively stronger or weaker than key rivals?
5. What strategic issues and problems merit front-burner managerial attention?

The answers to these five questions complete management's understanding of *"Where are we now?"* and position the company for a good strategy situation fit required of the *"Three Tests of a Winning Strategy"* (see Chapter 1, page 9).

Question 1: How Well Is the Company's Strategy Working?

The two best indicators of how well a company's strategy is working are (1) whether the company is achieving its stated financial and strategic objectives and (2) whether the company is an above-average industry performer. Persistent shortfalls in meeting company performance targets and weak performance relative to rivals are reliable warning signs that the company suffers from poor strategy making, less-than-competent strategy execution, or both. Other indicators of how well a company's strategy is working include:

- Trends in the company's sales and earnings growth.
- Trends in the company's stock price.
- The company's overall financial strength.
- The company's customer retention rate.
- The rate at which new customers are acquired.
- Changes in the company's image and reputation with customers.
- Evidence of improvement in internal processes such as defect rate, order fulfillment, delivery times, days of inventory,an de mployeep roductivity.

The stronger a company's current overall performance, the less likely the need for radical changes in strategy. The weaker a company's financial performance and market standing, the more its current strategy must be questioned. (A compilation of financial ratios most commonly used to evaluate a company's financial performance and balance sheet strength is presented in the Appendix on pages 240–241).

Question 2: What Are the Company's Competitively Important Resources and Capabilities?

A **resource-based strategy** usesac ompany's valuable and rare resources and competitive capabilities to deliver value to customers in ways rivals find it difficult to match.

As discussed in Chapter 1, a company's business model and strategy must be well-matched to its collection of resources and capabilities. An attempt by management to create and deliver customer value in a manner that depends on resources or capabilities that are deficient and cannot be readily acquired is unwise and positions the company for failure. A company's competitive approach requires a tight fit with a company's internal situation and is strengthened when it exploits resources that are competitively valuable, rare, hard to copy, and not easily trumped by rivals' equivalent substitute resources. In fact, many companies pursue ***resource-based strategies*** *that attempt to exploit company resources in a manner that offers value to customers in ways rivals are unable to match.*[1]

For example, a company pursuing a cost-based advantage might invest in super-efficient distribution centers that give it the capability to distribute its products at a lower cost than rivals. Walmart is well-known for its low-cost distribution and its distribution efficiency is one factor in its ability to underprice rivals. Over a period of more than a decade, Dell has put considerable time and money into cultivating relationships with its key suppliers that give it unmatched supply chain capabilities. Real-time information sharing between Dell and its suppliers allows many Dell plants to operate with only several hours' inventory of certain parts and components because the suppliers have online access to Dell's daily production schedule. Competitively valuable resources and capabilities can also facilitate differentiation in the marketplace. Because Fox News and CNN have the capability to devote more air time to breaking news stories and get reporters on the scene very quickly compared to the major networks like ABC, NBC, and CBS, many viewers turn to the cable networks when a major news event occurs.

[1] In the past decade, there's been considerable research into the role a company's resources and competitive capabilities play in crafting strategy and in determining company profitability. The findings and conclusions have coalesced into what is called the resource-based view of the firm. Among the most insightful publications on the topic are Birger Wernerfelt, "A Resource-Based View of the Firm," *Strategic Management Journal*, September–October 1984, pp. 171–180; Jay Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management* 17, no. 1 (1991), pp. 99–120; Margaret A. Peteraf, "The Cornerstones of Competitive Advantage: A Resource-Based View," *Strategic Management Journal*, March 1993, pp. 179–191; Birger Wernerfelt, "The Resource-Based View of the Firm: Ten Years After," *Strategic Management Journal* 16 (1995), pp. 171–174; Jay B. Barney, "Looking Inside for Competitive Advantage," *Academy of Management Executive* 9, no. 4 (November 1995), pp. 49–61; Christopher A. Bartlett and Sumantra Ghoshal, "Building Competitive Advantage through People," *MIT Sloan Management Review* 43, no 2, (Winter 2002), pp. 34–41; Danny Miller, Russell Eisenstat, and Nathaniel Foote, "Strategy from the Inside Out: Building Capability-Creating Organizations," *California Management Review* 44, no. 3 (Spring 2002), pp. 37–54; and Jay B. Barney and Delwyn N. Clark, *Resource-Based Theory: Creating and Sustaining Competitive Advantage* (New York: Oxford University Press, 2007).

Identifying Competitively Important Resources and Capabilities

Common types of valuable resources and competitive capabilities that management should consider when crafting strategy include:

- *A skill, specialized expertise, or competitively important capability*—examples include skills in low-cost operations, proven capabilities in creating and introducing innovative products, cutting-edge supply chain management capabilities, expertise in getting new products to market quickly, and expertise in providing consistently good customer service.
- *Valuable physical assets*—such as state-of-the-art plants and equipment, attractive real estate locations, or ownership of valuable natural resource deposits.
- *Valuable human assets and intellectual capital*—an experienced and capable workforce, talented employees in key areas, collective learning embedded in the organization, or proven managerial know-how.[2]
- *Valuable organizational assets*—proven quality control systems, proprietary technology, key patents, and a strong network of distributors or retail dealers.
- *Valuable intangible assets*—a powerful or well-known brand name or strong buyer loyalty.
- *Competitively valuable alliances or cooperative ventures*—alliances or joint ventures that provide access to valuable technologies, specialized know-how, or geographic markets.

Determining the Competitive Power of a Company Resource

What is most telling about a company's aggregation of resources is how powerful they are in the marketplace. The competitive power of a resource is measured by how many of the following four tests it can pass:[3]

1. *Is the resource really competitively valuable?* All companies possess a collection of resources and capabilities—some have the potential to contribute to a competitive advantage while others may not. Apple's operating

[2] Many business organizations are coming to view cutting-edge knowledge and the intellectual resources of company personnel as a valuable competitive asset and have concluded that explicitly managing these assets is an essential part of their strategy. See Michael H. Zack, "Developing a Knowledge Strategy," *California Management Review* 41, no. 3 (Spring 1999), pp. 125–145; and Shaker A. Zahra, Anders P. Nielsen, and William C. Bogner, "Corporate Entrepreneurship, Knowledge, and Competence Development," *Entrepreneurship Theory and Practice*, Spring 1999, pp. 169–189.

[3] See Jay B. Barney, "Firm Resources and Sustained Competitive Advantage," *Journal of Management* 17, no. 1 (1991), pp. 105–109; and Jay B. Barney and Delwyn N. Clark, *Resource-Based Theory: Creating and Sustaining Competitive Advantage* (New York: Oxford University Press, 2007). Also see M. A. Peteraf, "The Cornerstones of Competitive Advantage: A Resource-Based View," *Strategic Management Journal* 14 (1993), pp. 179–191; and David J. Collis and Cynthia A. Montgomery, "Competing on Resources: Strategy in the 1990s," *Harvard Business Review* 73, no. 4 (July–August 1995), pp. 120–123.

system for its MacIntosh PCs is by most accounts a world beater (compared to Windows Vista) but Apple has failed miserably in converting its resource strength in operating system design into competitive success in the global PC market.

2. *Is the resource rare—is it something rivals lack?* Companies have to guard against pridefully believing that their collection of resources and competitive capabilities is more powerful than that of their rivals. Who can really say whether Coca-Cola's consumer marketing prowess is better than Pepsi-Cola's or whether the Mercedes-Benz brand name is more powerful than that of BMW or Lexus? Although many retailers claim to be quite proficient in product selection and in-store merchandising, a number run into trouble in the marketplace because they encounter rivals whose capabilities in product selection and in-store merchandising are equal to or better than theirs.
3. *Is the resource hard to copy or imitate?* The more difficult and more expensive it is to imitate a company's resource or capability, the greater its potential competitive value. Resources tend to be difficult to copy when they are unique (a fantastic real estate location, patent protection), when they must be built over time (a brand name, a strategy supportive organizational culture), and when they carry big capital requirements (a cost-effective plant to manufacture cutting-edge microprocessors). Walmart's competitors have failed miserably in their attempts over the past two decades to match its state-of-the-art distribution capabilities.
4. *Can the resource be trumped by substitute resource strengths and competitive capabilities?* Resources that are competitively valuable, rare, and costly to imitate lose their ability to offer competitive advantage if rivals possess equivalent substitute resources. For example, manufacturers relying on automation to gain a cost-based advantage in production activities may find their technology-based advantage nullified by rivals' use of low-wage offshore manufacturing. Resources can contribute to a competitive advantage only when resource substitutes don't exist.

Understanding the nature of competitively important resources allows managers to identify resources or capabilities that should be further developed to play an important role in the company's future strategies. In addition, management may determine that it doesn't possess a resource that independently passes all four tests listed here with high marks, but does have a *bundle of resources* that can be leveraged to support its business model and strategy. Although Nike's resources dedicated to research and development, marketing research, and product design are matched relatively well by rival adidas, its cross-functional design process allows it to set the pace for innovation in athletic apparel and footwear and consistently outperform adidas and other rivals in the marketplace. Nike's footwear designers get ideas for new performance features from the professional athletes who endorse its products and then work alongside footwear materials researchers, consumer trend analysts, color designers, and marketers to design new models that are presented to a review committee. Nike's review committee is made up of hundreds of individuals who evaluate prototype details such as shoe proportions and color designs, the size of the swoosh, stitching patterns, sole color and tread pattern, and insole design. About 400 models are approved by the committee each year, which are sourced from contract manufacturers and marketed in more than 180 countries. The bundling of Nike's professional endorsements, R&D activities, marketing research efforts, styling expertise, and managerial know-how has become an important source of the company's competitive advantage and has allowed it to remain number one in the athletic footwear and apparel industry for more than 20 years.

Companies that lack a stand-alone resource that is competitively powerful may nonetheless develop a competitive advantage through **bundled resources.**

Resource-based strategies can also be directed at eroding or at least neutralizing the competitive potency of a particular rival's resources and capabilities by identifying and developing **substitute resources** to accomplish the same purpose. For example, Amazon.com lacks a big network of retail stores to compete with those operated by rival Barnes & Noble, but Amazon's much larger, readily accessible, and searchable book inventory—coupled with its short delivery times and free shipping on orders over $25—are more attractive to many busy consumers than visiting a big-box bookstore. In other words, Amazon has carefully and consciously developed a set of competitively valuable resources that are proving to be effective substitutes for competing head-to-head against Barnes and Noble without having to invest in hundreds of brick-and-mortar retail stores. Whereas many cosmetics companies sell their products through department stores and specialty retailers, Avon and Mary Kay Cosmetics have substituted for the lack of a retail dealer network by assembling a direct sales force numbering in the hundreds of thousands—their sales associates can personally demonstrate products to interested buyers in their homes or at parties, take orders on the spot, and deliver the items to buyers' homes.[4]

Rather than try to match the resources and capabilities possessed by a rival company, a company may develop entirely different resources and capabilities that substitute for the strengths of the rival.

Resources and Capabilities as the Foundation of Competitive Advantage

One of the most important aspects of identifying resources and capabilities that can become the basis for competitive advantage has to do with a company's competence level in performing key pieces of its business—such as supply chain management, R&D, production, distribution, sales and marketing, and customer service. A company's proficiency in conducting different facets of its operations can range from merely the ability to perform an activity to a competence, core competence, or distinctive competence:

1. A **competence** is an internal activity an organization performs with proficiency. Some competencies relate to fairly specific skills and expertise (like just-in-time inventory control or picking locations for new stores) and may be performed in a single department or organizational unit.

[4] For a more detailed discussion, see George Stalk, Philip Evans, and Lawrence E. Schulman, "Competing on Capabilities: The New Rules of Corporate Strategy," *Harvard Business Review* 70, no. 2 (March–April 1992), pp. 57–69.

Other competencies, however, are inherently multidisciplinary and cross-functional. A competence in continuous product innovation, for example, comes from the bundled efforts of people and groups with expertise in market research, new product R&D, design and engineering, cost-effective manufacturing, and market testing.

> A **competence** is an activity that a company performsw ell.

2. A **core competence** is a proficiently performed internal activity that is *central* to a company's strategy and competitiveness. A core competence is a highly valuable capability because of the contribution it makes to the company's success in the marketplace. A company may have more than one core competence in its resource portfolio, but rare is the company that can legitimately claim more than two or three core competencies. Most often, *a core competence is knowledge-based, residing in people and in a company's intellectual capital and not in its assets on the balance sheet.* Moreover, a core competence is more likely to be grounded in cross-department combinations of knowledge and expertise rather than being the product of a single department or work group. Facebook has a core competence in anticipating features that will appeal to Internet users who maintain social networking sites. The ability of Internet users to share information, photos, videos, and interesting news stories with friends and others made Facebook the world's largest social networking site as of 2009 with more than 90 million unique visitors each month.

> A **core competence** isac ompetitively important activity that a company performs better than other internal activities.

3. A **distinctive competence** is a competitively valuable activity that a company *performs better than its rivals.* Because a distinctive competence represents a uniquely strong capability relative to rival companies, it has significant competitive advantage potential. This is particularly true when the distinctive competence enables a company to deliver standout value to customers (in the form of lower prices or better product performance or superior service). Toyota has worked diligently over several decades to establish a distinctive competence in low-cost, high-quality manufacturing of motor vehicles; its "lean production" system is far superior to that of any other automaker's and the company is pushing the boundaries of its production advantage with a new Global Body assembly line. Toyota's Global Body assembly line costs 50 percent less to install and can be changed to accommodate a new model for 70 percent less than its previous production system.[5] The conceptual differences between a competence, a core competence, and a distinctive competence draw attention to the fact that a company's resources and competitive capabilities are not all equal.[6] Some capabilities

> A **distinctive competence** isac ompetitively important activity that a company performs better than its rivals—therefore offering the potentialf orc ompetitivead vantage.

[5] George Stalk, Jr. and Rob Lachenauer, "Hard Ball: Five Killer Strategies for Trouncing the Competition," *Harvard Business Review* 82, no. 4 (April 2004), p. 65.

[6] For a more extensive discussion of how to identify and evaluate the competitive power of a company's capabilities, see David W. Birchall and George Tovstiga, "The Strategic Potential of a Firm's Knowledge Portfolio," *Journal of General Management* 25, no. 1 (Autumn 1999), pp. 1–16; and David Teece, "Capturing Value from Knowledge Assets: The New Economy, Markets for Know-How, and Intangible Assets," *California Management Review* 40, no. 3 (Spring 1998), pp. 55–79.

and competencies merely enable market survival because most rivals have them. Core competencies are *competitively* more important than competencies because they add power to the company's strategy and have a bigger positive impact on its market position and profitability. Distinctive competencies are even more competitively important. A distinctive competence is competitively potent for three reasons: (1) It gives a company competitively valuable capability that is unmatched by rivals, (2) it has potential for being the cornerstone of the company's strategy, and (3) it can produce a competitive edge in the marketplace.

Taking Inventory of a Company's Internal Resource Strengths and Weaknesses and Its External Opportunities and Threats

An appraisal of a company's resource **s**trengths and **w**eaknesses can be coupled with a listing of external **o**pportunities and **t**hreats to provide an overview of the company's overall situation. Such an assessment, commonly known as **SWOT analysis,** provides the basis for crafting a strategy that capitalizes on the company's strengths, aims squarely at capturing the company's best opportunities, and defends against the threats to its well-being.

> **SWOT analysis** is a simple but powerful tool for sizing up a company's resource strengths and competitive deficiencies, its market opportunities, and the external threats to its futurew ell-being.

IDENTIFYING COMPANY RESOURCE STRENGTHS AND CORE COMPETENCIES A company's resource strengths represent its competitive assets and determine whether its competitive power in the marketplace will be impressively strong or disappointingly weak. A company that is well-endowed with potent resource strengths and core competencies normally has considerable competitive power—especially when its management team skillfully utilizes the company's resources in ways that build sustainable competitive advantage. Companies with modest or weak competitive assets nearly always are relegated to a trailing position in the industry. Table 4.1 lists the kinds of factors to consider in compiling a company's resource strengths and weaknesses.

IDENTIFYING COMPANY RESOURCE WEAKNESSES AND COMPETITIVE DEFICIENCIES A *resource weakness* or *competitive liability* is something a company lacks or does poorly or a condition that puts it at a disadvantage in the marketplace. As a rule, strategies that place heavy demands on areas where the company is weakest or has unproven ability are suspect and should be avoided. A company's resource weaknesses can relate to:

- Inferior or unproven skills, expertise, or intellectual capital in competitively important areas of the business.
- Deficiencies in competitively important physical, organizational, or intangibleas sets.
- Missing or competitively inferior capabilities in key areas.

Table 4.1

Factors to Consider When Identifying a Company's Strengths, Weaknesses, Opportunities, and Threats

Potential Resource Strengths and Competitive Capabilities

- Core competencies in ______.
- A strong financial condition; ample financial resources to grow the business.
- Strong brand name image/company reputation.
- Economy of scale and/or learning and experience curve advantages over rivals.
- Proprietary technology/superior technological skills/important patents.
- Cost advantages over rivals.
- Product innovation capabilities.
- Proven capabilities in improving production processes.
- Good supply chain management capabilities.
- Good customer service capabilities.
- Better product quality relative to rivals.
- Wide geographic coverage and/or strong global distribution capability.
- Alliances/joint ventures with other firms that provide access to valuable technology, competencies, and/or attractive geographic markets.

Potential Market Opportunities

- Serving additional customer groups or market segments.
- Expanding into new geographic markets.
- Expanding the company's product line to meet a broader range of customer needs.
- Utilizing existing company skills or technological know-how to enter new product lines or new businesses.
- Falling trade barriers in attractive foreign markets.
- Acquiring rival firms or companies with attractive technological expertise or capabilities.

Potential Resource Weaknesses and Competitive Deficiencies

- No clear strategic direction.
- No well-developed or proven core competencies.
- A weak balance sheet; burdened with too much debt.
- Higher overall unit costs relative to key competitors.
- A product/service with features and attributes that are inferior to those of rivals.
- Too narrow a product line relative to rivals.
- Weak brand image or reputation.
- Weaker dealer network than key rivals.
- Behind on product quality, R&D, and/or technological know-how.
- Lack of management depth.
- Short on financial resources to grow the business and pursue promising initiatives.

Potential External Threats to a Company's Future Prospects

- Increasing intensity of competition among industry rivals—may squeeze profit margins.
- Slowdowns in market growth.
- Likely entry of potent new competitors.
- Growing bargaining power of customers or suppliers.
- A shift in buyer needs and tastes away from the industry's product.
- Adverse demographic changes that threaten to curtail demand for the industry's product.
- Vulnerability to unfavorable industry driving forces.
- Restrictive trade policies on the part of foreign governments.
- Costly new regulatory requirements.

Nearly all companies have competitive liabilities of one kind or another. Whether a company's resource weaknesses make it competitively vulnerable depends on how much they matter in the marketplace and whether they are offset by the company's resource strengths. Sizing up a company's complement of resource capabilities and deficiencies is akin to constructing a *strategic balance sheet*, where resource strengths represent *competitive assets* and resource weaknesses represent *competitive liabilities.*

A company's resource strengths represent competitive assets; its resource weaknesses represent competitive liabilities.

IDENTIFYING A COMPANY'S MARKET OPPORTUNITIES Market opportunity is a big factor in shaping a company's strategy. Indeed, managers can't properly tailor strategy to the company's situation without first identifying its market opportunities and appraising the growth and profit potential each one holds. (See Table 4.1, under "Potential Market Opportunities.") Depending on the prevailing circumstances, a company's opportunities can be plentiful or scarce and can range from wildly attractive to unsuitable.

In evaluating the attractiveness of a company's market opportunities, managers have to guard against viewing every *industry* opportunity as a suitable opportunity. Not every company is equipped with the resources to successfully pursue each opportunity that exists in its industry. Some companies are more capable of going after particular opportunities than others. *The market opportunities most relevant to a company are those that match up well with the company's financial and organizational resources and capabilities, offer the best growth and profitability, and present the most potential for competitive advantage.*

IDENTIFYING THREATS TO A COMPANY'S FUTURE PROFITABILITY Often, certain factors in a company's external environment pose *threats* to its profitability and competitive well-being. Threats can stem from the emergence of cheaper or better technologies, rivals' introduction of new or improved products, the entry of lower-cost foreign competitors into a company's market stronghold, new regulations that are more burdensome to a company than to its competitors, vulnerability to a rise in interest rates, the potential of a hostile takeover, unfavorable demographic shifts, or adverse changes in foreign exchange rates. (See Table 4.1, under "Potential External Threats to a Company's Future Prospects.")

External threats may pose no more than a moderate degree of adversity or they may be so imposing as to make a company's situation and outlook quite tenuous. On rare occasions, market shocks can throw a company into an immediate crisis and battle to survive. Many of the world's major airlines have been plunged into unprecedented financial crisis because of a combination of factors: rising prices for jet fuel, a global economic slowdown that has affected business and leisure travel, mounting competition from low-fare carriers, shifting traveler preferences for low fares as opposed to lots of in-flight amenities, and "out-of-control" labor costs. It is management's job to identify the threats to the company's future prospects and to evaluate what strategic actions can be taken to neutralize or lessen their impact.

THE VALUE OF A SWOT ANALYSIS A SWOT analysis involves more than making four lists. The most important parts of SWOT analysis are:

Simply making lists of a company's strengths, weaknesses, opportunities, and threats is not enough; the payoff from SWOT analysis comes from the conclusions about a company's situation and the implications for strategy improvement that flow from the four lists.

1. Drawing conclusions from the SWOT listings about the company's overall situation.
2. Translating these conclusions into strategic actions to better match the company's strategy to its resource strengths and market opportunities, correcting problematic weaknesses, and defending against worrisome external threats.

Question 3: Are the Company's Costs and Prices Competitive?

Company managers are often stunned when a competitor cuts its prices to "unbelievably low" levels or when a new market entrant comes on strong with a very low price. The competitor may not, however, be buying its way into the market with super-low prices that are below its costs—it may simply have substantially lower costs. One of the most telling signs of whether a company's business position is strong or precarious is whether its prices and costs are competitive with industry rivals.

Price and cost comparisons are especially critical in industries where price competition is typically the ruling market force. But even in industries where products are differentiated, rival companies have to keep their costs in line with rivals offering a similar mix of differentiating features. Two analytical tools are particularly useful in determining whether a company's prices and costs are competitive: value chain analysis and benchmarking.

Company Value Chains

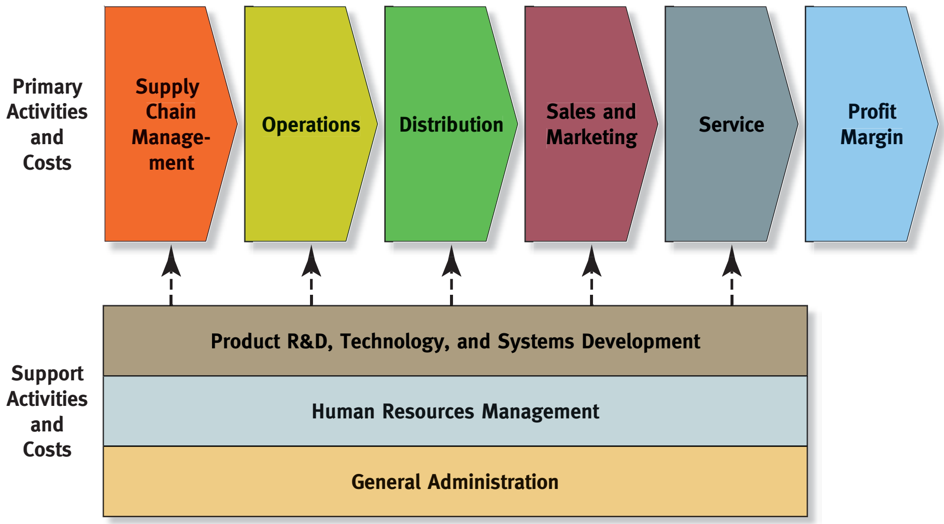
Every company's business consists of a collection of activities undertaken in the course of designing, producing, marketing, delivering, and supporting its product or service. All of the various activities that a company performs internally combine to form a **value chain,** so-called because the underlying intent of a company's activities is to do things that ultimately *create value for buyers.* A company's value chain also includes an allowance for profit because it is customarily part of the price (or total cost) borne by buyers.

Ac ompany's **value chain** identifiesthe p rimary activities that create customer value and related supportac tivities.

As shown in Figure 4.1, a company's value chain consists of two broad categories of activities: the *primary activities* that are foremost in creating value for customers and the requisite *support activities* that facilitate and enhance the performance of the primary activities.[7] For example, the primary activities for a big box retailer include merchandise selection and buying, store layout and product display, advertising, and customer service; its support activities

[7] The value chain concept was developed and articulated by professor Michael Porter at the Harvard Business School and is described at greater length in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), Chapters 2 and 3.

FIGURE 4.1 **A Representative Company Value Chain**



PRIMARY ACTIVITIES

- **Supply Chain Management**—Activities, costs, and assets associated with purchasing fuel, energy, raw materials, parts and components, merchandise, and consumable items from vendors; receiving, storing, and disseminating inputs from suppliers; inspection; and inventory management.

- **Operations**—Activities, costs, and assets associated with converting inputs into final product form (production, assembly, packaging, equipment maintenance, facilities, operations, quality assurance, environmental protection).

- **Distribution**—Activities, costs, and assets dealing with physically distributing the product to buyers (finished goods warehousing, order processing, order picking and packing, shipping, delivery vehicle operations, establishing and maintaining a network of dealers and distributors).

- **Sales and Marketing**—Activities, costs, and assets related to sales force efforts, advertising and promotion, market research and planning, and dealer/distributor support.

- **Service**—Activities, costs, and assets associated with providing assistance to buyers, such as installation, spare parts delivery, maintenance and repair, technical assistance, buyer inquiries, and complaints.

SUPPORT ACTIVITIES

- **Product R&D, Technology, and Systems Development**—Activities, costs, and assets relating to product R&D, process R&D, process design improvement, equipment design, computer software development, telecommunications systems, computer-assisted design and engineering, database capabilities, and development of computerized support systems.

- **Human Resources Management**—Activities, costs, and assets associated with the recruitment, hiring, training, development, and compensation of all types of personnel; labor relations activities; and development of knowledge-based skills and core competencies.

- **General Administration**—Activities, costs, and assets relating to general management, accounting and finance, legal and regulatory affairs, safety and security, management information systems, forming strategic alliances and collaborating with strategic partners, and other "overhead" functions.

Source: Based on the discussion in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), pp. 37–43.

include site selection, hiring and training, store maintenance, plus the usual assortment of administrative activities. A hotel chain's primary activities and costs are mainly comprised of reservations and hotel operations (check-in and check-out, maintenance and housekeeping, dining and room service, and conventions and meetings); principal support activities include accounting, hiring and training hotel staff, and general administration. Supply chain management is a crucial activity for Nissan, L.L. Bean, and Petsmart but is not a value chain component at Google or Bank of America. Sales and marketing are dominant activities at Procter & Gamble and Sony but have minor roles at oil drilling companies and natural gas pipeline companies. Whether an activity is classified as primary or supporting varies with each company's business model and strategy, so it is important to view the listing of the primary and support activities in Figure 4.1 as illustrative rather than definitive.

Benchmarking: A Tool for Assessing Whether a Company's Value Chain Activities Are Competitive

Benchmarking entails comparing how different companies perform various value chain activities—how materials are purchased, how inventories are managed, how products are assembled, how customer orders are filled and shipped, and how maintenance is performed—and then making cross-company comparisons of the costs and effectiveness of these activities.[8] The objectives of benchmarking are to identify the best practices in performing an activity and to emulate those best practices when they are possessed by others.

Xerox became one of the first companies to use benchmarking in 1979 when Japanese manufacturers began selling midsize copiers in the United States for $9,600 each—less than Xerox's production costs.[9] Xerox management sent a team of line managers and its head of manufacturing to Japan to study competitors' business processes and costs. With the aid of Xerox's joint venture partner in Japan (Fuji-Xerox), who knew the competitors well, the team found that Xerox's costs were excessive due to gross inefficiencies in the company's manufacturing processes and business practices. The findings triggered a major internal effort at Xerox to become cost-competitive and prompted Xerox to begin benchmarking 67 of its key work processes. Xerox quickly decided not to restrict its benchmarking efforts to its office equipment rivals but to extend them to any company regarded as "world class" in performing *any activity* relevant to Xerox's business. Other companies quickly picked up on Xerox's approach. Toyota managers got their idea for just-in-time inventory deliveries by studying how U.S. supermarkets replenished their shelves. Southwest Airlines reduced the turnaround time of its aircraft at each scheduled stop by studying pit crews on the auto racing circuit. Over 80 percent of Fortune 500 companies reportedly use benchmarking for comparing themselves against rivals on cost and other competitively important measures.

Benchmarking is a potent tool for learning which companies are best at performing particular activities and then using their techniques (or "best practices") to improve the cost and effectiveness of a company's own internal activities.

[8] For more details, see Gregory H. Watson, *Strategic Benchmarking: How to Rate Your Company's Performance Against the World's Best* (New York: John Wiley, 1993); Robert C. Camp, *Benchmarking: The Search for Industry Best Practices That Lead to Superior Performance* (Milwaukee: ASQC Quality Press, 1989); Christopher E. Bogan and Michael J. English, *Benchmarking for Best Practices: Winning through Innovative Adaptation* (New York: McGraw-Hill, 1994); and Dawn Iacobucci and Christie Nordhielm, "Creative Benchmarking," *Harvard Business Review* 78, no. 6 (November–December 2000), pp. 24–25.

[9] Jeremy Main, "How to Steal the Best Ideas Around," *Fortune*, October 19, 1992, pp. 102–103.

The tough part of benchmarking is not whether to do it, but rather how to gain access to information about other companies' practices and costs. Sometimes benchmarking can be accomplished by collecting information from published reports, trade groups, and industry research firms and by talking to knowledgeable industry analysts, customers, and suppliers. Sometimes field trips to the facilities of competing or noncompeting companies can be arranged to observe how things are done, compare practices and processes, and perhaps exchange data on productivity and other cost components. However, such companies, even if they agree to host facilities tours and answer questions, are unlikely to share competitively sensitive cost information. Furthermore, comparing two companies' costs may not involve comparing apples to apples if the two companies employ different cost accounting principles to calculate the costs of particular activities.

However, a fairly reliable source of benchmarking information has emerged. The explosive interest of companies in benchmarking costs and identifying best practices has prompted consulting organizations (e.g., Accenture, A. T. Kearney, Benchnet—The Benchmarking Exchange, Towers Perrin, and Best Practices, LLC) and several councils and associations (e.g., the APQC, the Qualserve Benchmarking Clearinghouse, and the Strategic Planning Institute's Council on Benchmarking) to gather benchmarking data, distribute information about best practices, and provide comparative cost data without identifying the names of particular companies. Having an independent group gather the information and report it in a manner that disguises the names of individual companies avoids the disclosure of competitively sensitive data and lessens the potential for unethical behavior on the part of company personnel in gathering their own data about competitors.

The Value Chain System for an Entire Industry

A company's value chain is embedded in a larger system of activities that includes the value chains of its suppliers and the value chains of whatever distribution channel allies it utilizes in getting its product or service to end users.[10] The value chains of forward channel partners are relevant because (1) the costs and margins of a company's distributors and retail dealers are part of the price the consumer ultimately pays, and (2) the activities that distribution allies perform affect customer satisfaction. For these reasons, companies normally work closely with their suppliers and forward channel allies to perform value chain activities in mutually beneficial ways. For instance, motor vehicle manufacturers work closely with their forward channel allies (local automobile dealers) to ensure that owners are satisfied with dealers' repair and maintenance services.[11] Also, many automotive parts

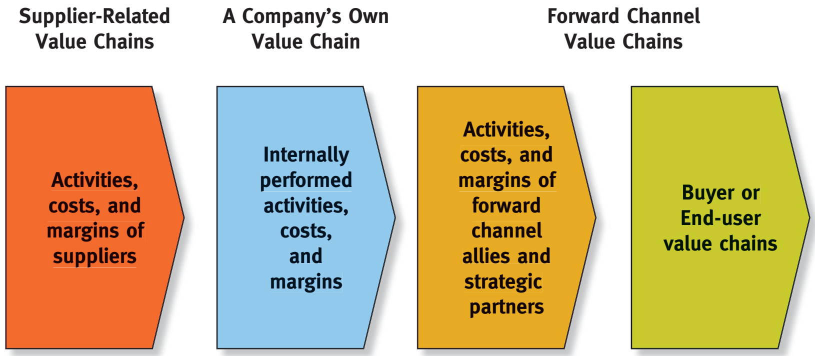
A company's cost-competitiveness depends not only on the costs of internally performed activities (its own company value chain), but also on costs in the value chains of its suppliers and forward channel allies.

[10] Porter, *Competitive Advantage*, p. 34.

[11] M. Hegert and D. Morris, "Accounting Data for Value Chain Analysis," *Strategic Management Journal* 10 (1989), p. 180; Robin Cooper and Robert S. Kaplan, "Measure Costs Right: Make the Right Decisions," *Harvard Business Review* 66, no. 5 (September–October 1988), pp. 96–103; and John K. Shank and Vijay Govindarajan, *Strategic Cost Management* (New York: Free Press, 1993), especially Chapters 2–6, 10.

FIGURE 4.2 **Representative Value Chain for an Entire Industry**

Source: Based in part on the single-industry value chain displayed in Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), p. 35.



suppliers have built plants near the auto assembly plants they supply to facilitate just-in-time deliveries, reduce warehousing and shipping costs, and promote close collaboration on parts design and production scheduling. Irrigation equipment companies, suppliers of grape-harvesting and wine-making equipment, and firms making barrels, wine bottles, caps, corks, and labels all have facilities in the California wine country to be close to the nearly 700 winemakers they supply.[12] The lesson here is that a company's value chain activities are often closely linked to the value chains of their suppliers and the forward allies.

As a consequence, *accurately assessing a company's competitiveness requires that company managers understand an industry's entire value chain system for delivering a product or service to customers, not just the company's own value chain.* A typical industry value chain that incorporates the activities, costs, and margins of suppliers and forward channel allies (if any) is shown in Figure 4.2. However, industry value chains vary significantly by industry. For example, the primary value chain activities in the bottled water industry (spring operation or water purification, processing of basic ingredients used in flavored or vitamin-enhanced water, bottling, wholesale distribution, advertising, and retail merchandising) differ from those for the computer software industry (programming, disk loading, marketing, distribution). Producers of bathroom and kitchen faucets depend heavily on the activities of wholesale distributors and building supply retailers in winning sales to homebuilders and do-it-yourselfers but producers of papermaking machines internalize their distribution activities by selling directly to the operators of paper plants. Concepts & Connections 4.1 shows representative costs for various activities performed by the producers and marketers of music CDs.

Strategic Options for Remedying a Cost Disadvantage

There are three main areas in a company's overall value chain where important differences in the costs of competing firms can occur: a company's own internal activities, the suppliers' part of the industry value chain, and the forward channel portion of the industry chain.

[12] For more on how and why the clustering of suppliers and other support organizations matter to a company's costs and competitiveness, see Michael E. Porter, "Clusters and the New Economics of Competition," *Harvard Business Review* 76, no. 6 (November–December 1998), pp. 77–90.

Concepts & Connections 4.1

ESTIMATED COSTS FOR VALUE CHAIN ACTIVITIES IN THE RECORDING INDUSTRY

The table below presents the representative costs and markups associated with producing and distributing a music CD retailing for $15 in music stores (as opposed to Internet sources).

Value Chain Activities and Costs in Producing and Distributing a CD		
1. Record company direct production costs:		$ 2.40
Artists and repertoire	$0.75	
Pressing of CD and packaging	1.65	
2. Royalties		.99
3. Record company marketing expenses		1.50
4. Record company overhead		1.50
5. Total record company costs		6.39
6. Record company's operating profit		1.86
7. Record company's selling price to distributor/wholesaler		8.25
8. Average wholesale distributor markup to cover distribution activities and profit margins		1.50
9. Average wholesale price charged to retailer		9.75
10. Average retail markup over wholesale cost		5.25
11. Average price to consumer at retail		$15.00

Source: Developed from information in "Fight the Power," a case study prepared by Adrian Aleyne, Babson College, 1999.

REMEDYING AN INTERNAL COST DISADVANTAGE When a company's cost disadvantage stems from performing internal value chain activities at a higher cost than key rivals, then managers can pursue any of several strategic approaches to restore cost parity:[13]

1. *Implement the use of best practices* throughout the company, particularly for high-costac tivities.
2. *Try to eliminate some cost-producing activities altogether* by revamping the value chain. Many retailers have found that donating returned items to charitable organizations and taking the appropriate tax deduction results in a smaller loss than incurring the costs of the value chain activities involved in reverse logistics.
3. *Relocate high-cost activities* (such as manufacturing) to geographic areas like China, Latin America, or Eastern Europe where they can be performed more cheaply.
4. *See if certain internally performed activities can be outsourced* from vendors or performed by contractors more cheaply than they can be done in-house.
5. *Invest in productivity enhancing, cost-saving technological improvements* (robotics, flexible manufacturing techniques, state-of-the-art electronic networking).

[13] Some of these options are discussed in more detail in Porter, *Competitive Advantage*, Chapter 3.

6. *Find ways to detour around the activities or items where costs are high*—computer chip makers regularly design around the patents held by others to avoid paying royalties; automakers have substituted lower-cost plastic for metal at many exterior body locations.
7. Redesign the product and/or some of its components to facilitate speedier and more economical manufacture or assembly.
8. Try to make up the internal cost disadvantage by reducing costs in the supplier or forward channel portions of the industry value chain—usually a last resort.

REMEDYING A SUPPLIER-RELATED COST DISADVANTAGE Supplier-related cost disadvantages can be attacked by pressuring suppliers for lower prices, switching to lower-priced substitute inputs, and collaborating closely with suppliers to identify mutual cost-saving opportunities.[14] For example, just-in-time deliveries from suppliers can lower a company's inventory and internal logistics costs, eliminate capital expenditures for additional warehouse space, and improve cash flow and financial ratios by reducing accounts payable. In a few instances, companies may find that it is cheaper to integrate backward into the business of high-cost suppliers and make the item in-house instead of buying it from outsiders.

REMEDYING A COST DISADVANTAGE ASSOCIATED WITH ACTIVITIES PERFORMED BY FORWARD CHANNEL ALLIES There are three main ways to combat a cost disadvantage in the forward portion of the industry value chain: (1) Pressure dealer-distributors and other forward channel allies to reduce their costs and markups; (2) work closely with forward channel allies to identify win-win opportunities to reduce costs—for example, a chocolate manufacturer learned that by shipping its bulk chocolate in liquid form in tank cars instead of 10-pound molded bars, it could not only save its candy bar manufacturing customers the costs associated with unpacking and melting but also eliminate its own costs of molding bars and packing them; and (3) change to a more economical distribution strategy or perhaps integrate forward into company-owned retail outlets. Dell Computer has eliminated all activities, costs, and margins of forward channel allies by adopting a direct sales business model that allows buyers to purchase customized PCs directly from the manufacturer. The direct sales model allows Dell to easily match competitors' prices, while earning larger profit margins.

Question 4: What Is the Company's Competitive Strength Relative to Key Rivals?

An additional component of evaluating a company's situation is developing a comprehensive assessment of the company's overall competitive strength. Making this determination requires answers to two questions:

[14] An example of how Whirlpool Corporation transformed its supply chain from a competitive liability to a competitive asset is discussed in Reuben E. Stone, "Leading a Supply Chain Turnaround," *Harvard Business Review* 82, no. 10 (October 2004), pp. 114–121.

1. How does the company rank relative to competitors on each of the important factors that determine market success?
2. All things considered, does the company have a net competitive advantage or disadvantage versus major competitors?

Step 1 in doing a competitive strength assessment is to make a list of the industry's key success factors and other telling measures of competitive strength or weakness (6 to 10 measures usually suffice). Step 2 is to assign a weight to each measure of competitive strength based on its perceived importance in shaping competitive success. (The sum of the weights for each measure must add up to 1.0.) Step 3 is to calculate weighted strength ratings by scoring each competitor on each strength measure (using a 1 to 10 rating scale where 1 is very weak and 10 is very strong) and multiplying the assigned rating by the assigned weight. Step 4 is to sum the weighted strength ratings on each factor to get an overall measure of competitive strength for each company being rated. Step 5 is to use the overall strength ratings to draw conclusions about the size and extent of the company's net competitive advantage or disadvantage and to take specific note of areas of strength and weakness. Table 4.2 provides an example of a competitive strength assessment, using the hypothetical ABC Company against four rivals. ABC's total score of 5.95 signals a net competitive advantage over Rival 3 (with a score of 2.10) and Rival 4 (with a score of 3.70), but indicates a net competitive disadvantage against Rival 1 (with a score of 7. 70) and Rival 2 (with an overall score of 6.85).

Interpretingt heC ompetitive Strength Assessments

Competitive strength assessments provide useful conclusions about a company's competitive situation. The ratings show how a company compares against rivals, factor by factor or capability by capability, thus revealing where it is strongest and weakest. Moreover, the overall competitive strength scores indicate whether the company is at a net competitive advantage or disadvantage against each rival.

In addition, the strength ratings provide guidelines for designing wise offensive and defensive strategies. For example, consider the ratings and weighted scores in Table 4.2. If ABC Co. wants to go on the offensive to win additional sales and market share, such an offensive probably needs to be aimed directly at winning customers away from Rivals 3 and 4 (which have lower overall strength scores) rather than Rivals 1 and 2 (which have higher overall strength scores). ABC's advantages over Rival 4 tends to be in areas that are moderately important to competitive success in the industry, but ABC outclasses Rival 3 on the two most heavily weighted strength factors—relative cost position and customer service capabilities. Therefore, Rival 3 should be viewed as the primary target of ABC's offensive strategies, with Rival 4 being a secondary target.

> A company's competitive strength scores pinpoint its strengths and weaknesses against rivals and point to offensive and defensive strategies capable of producing first-rate results.

The point here is that a competitively astute company should utilize the strength scores in deciding what strategic moves to make. When a company has important competitive strengths in areas where one or more rivals are weak,

Table 4.2

Illustration of a Competitive Strength Assessment

		ABC CO.		RIVAL 1		RIVAL 2		RIVAL 3		RIVAL 4	
Key Success Factor/Strength Measure	**Importance Weight**	**Strength Rating**	**Score**	**Strength Rating**	**Score**	**Strength Rating**	**Score**	**Strength Rating**	**Score**	**Strength Rating**	**Score**
Quality/product performance	0.10	8	0.80	5	0.50	10	1.00	1	0.10	6	0.60
Reputation/image	0.10	8	0.80	7	0.70	10	1.00	1	0.10	6	0.60
Manufacturing capability	0.10	2	0.20	10	1.00	4	0.40	5	0.50	1	0.10
Technological skills	0.05	10	0.50	1	0.05	7	0.35	3	0.15	8	0.40
Dealer network/distribution capability	0.05	9	0.45	4	0.20	10	0.50	5	0.25	1	0.05
New product innovation capability	0.05	9	0.45	4	0.20	10	0.50	5	0.25	1	0.05
Financial resources	0.10	5	0.50	10	1.00	7	0.70	3	0.30	1	0.10
Relative cost position	0.30	5	1.50	10	3.00	3	0.95	1	0.30	4	1.20
Customer service capabilities	0.15	5	0.75	7	1.05	10	1.50	1	0.15	4	0.60
Sum of importance weights	**1.00**										
Weighted overall strength rating			**5.95**		**7.70**		**6.85**		**2.10**		**3.70**

it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has competitive weaknesses in important areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.

Question 5: What Strategic Issues and Problems Must Be Addressed by Management?

The final and most important analytical step is to zero in on exactly what strategic issues company managers need to address. This step involves drawing on the results of both industry and competitive analysis and the evaluations of the company's internal situation. The task here is to get a clear fix on exactly what industry and competitive challenges confront the company, which of the company's internal weaknesses need fixing, and what specific problems merit front-burner attention by company managers. *Pinpointing the precise things that management needs to worry about sets the agenda for deciding what actions to take next to improve the company's performance and business outlook.*

Compiling a "worry list" of problems and issues creates an agenda for managerial strategy making.

If the items on management's "worry list" are relatively minor, which suggests the company's strategy is mostly on track and reasonably well matched to the company's overall situation, company managers seldom need to go much beyond fine-tuning the present strategy. If, however, the issues and problems confronting the company are serious and indicate the present strategy is not well suited for the road ahead, the task of crafting a better strategy has got to go to the top of management's action agenda.

KeyP oints

There are five key questions to consider in analyzing a company's own particular competitive circumstances and its competitive position vis-à-vis key rivals:

1. *How well is the present strategy working?* This involves evaluating the strategy from a qualitative standpoint (completeness, internal consistency, rationale, and suitability to the situation) and also from a quantitative standpoint (the strategic and financial results the strategy is producing). The stronger a company's current overall performance, the less likely the need for radical strategy changes. The weaker a company's performance and/or the faster the changes in its external situation (which can be gleaned from industry and competitive analysis), the more its current strategy must be questioned.
2. *What are the company's competitively important resources and capabilities?* A company's resources, competitive capabilities, and core competencies are strategically relevant because they are the most logical and appealing

building blocks for strategy. In fact, many companies pursue *resource-based strategies* that attempt to exploit company resources in a manner that offers value to customers in ways rivals are unable to match. The most potent resource-based strategies exploit resources which are *competitively valuable, rare, hard to copy or imitate, and are not easily trumped by substitute resources.* A *SWOT analysis* is a simple but powerful tool for sizing up a company's resource strengths and competitive deficiencies, its market opportunities, and the external threats to its future well-being. Resource weaknesses are important because they may represent vulnerabilities that need correction. External opportunities and threats come into play because a good strategy necessarily aims at capturing a company's most attractive opportunities and at defending against threats to its well-being.

3. *Are the company's prices and costs competitive?* One telling sign of whether a company's situation is strong or precarious is whether its prices and costs are competitive with those of industry rivals. Value chain analysis and benchmarking are essential tools in determining whether the company is performing particular functions and activities cost-effectively, learning whether its costs are in line with competitors, and deciding which internal activities and business processes need to be scrutinized for improvement. Value chain analysis teaches that how competently a company manages its value chain activities relative to rivals is a key to building a competitive advantage based on either better competencies and competitive capabilities or lower costs than rivals.
4. *Is the company competitively stronger or weaker than key rivals?* The key appraisals here involve how the company matches up against key rivals on industry key success factors and other chief determinants of competitive success and whether and why the company has a competitive advantage or disadvantage. Quantitative competitive strength assessments, using the method presented in Table 4.2, indicate where a company is competitively strong and weak and provide insight into the company's ability to defend or enhance its market position. As a rule a company's competitive strategy should be built around its competitive strengths and should aim at shoring up areas where it is competitively vulnerable. When a company has important competitive strengths in areas where one or more rivals are weak, it makes sense to consider offensive moves to exploit rivals' competitive weaknesses. When a company has important competitive weaknesses in areas where one or more rivals are strong, it makes sense to consider defensive moves to curtail its vulnerability.
5. *What strategic issues and problems merit front-burner managerial attention?* This analytical step zeros in on the strategic issues and problems that stand in the way of the company's success. It involves using the results of both industry and competitive analysis and company situation analysis to identify a "worry list" of issues to be resolved in order for the company to be financially and competitively successful in the years ahead. Actually deciding upon a strategy and what specific actions to take is what comes after the list of strategic issues and problems that merit front-burner management attention has been developed.

Good company situation analysis, like good industry and competitive analysis, is a valuable precondition for good strategy making.

Assurance of Learning Exercises

LO1 1. Usingt hefi nancial ratios provided in the Appendix and the financial statement information for Avon Products below, calculate the following ratios for Avon for both 2007 and 2008:

a. Grossp rofit margin
b. Operating profit margin
c. Netp rofit margin
d. Timesi ntereste arnedc overage
e. Returno ns hareholders'e quity
f. Returno nas sets
g. Debt-to-equityr atio
h. Dayso fi nventory
i. Inventoryt urnoverr atio
j. Averagec ollectionp eriod

Based on these ratios, did Avon's financial performance improve, weaken, or remain about the same from 2007 to 2008?

CONSOLIDATED STATEMENTS OF INCOME FOR AVON PRODUCTS, INC., 2007–2008
(in millions, except per share data)

Years ended December 31	**2008**	**2007**
Net sales	$ 10,588.9	$ 9,845.2
Other revenue	101.2	93.5
Total revenue	10,690.1	9,938.7
Costs, expenses and other:		
Cost of sales	3,949.1	3,941.2
Selling, general and administrative expenses	5,401.7	5,124.8
Operating profit	1,339.3	872.7
Interest expense	100.4	112.2
Interest income	(37.1)	(42.2)
Other expenses, net	37.7	6.6
Total other expenses	101.0	76.6
Income before taxes and minority interest	1,238.3	796.1
Income taxes	362.7	262.8
Income before minority interest	875.6	533.3
Minority interest	(0.3)	(2.6)
Net income	$ 875.3	$ 530.7
Earnings per share:		
Basic	$ 2.05	$ 1.22
Diluted	$ 2.04	$ 1.21
Weighted-average shares outstanding:		
Basic	426.36	433.47
Diluted	429.53	436.89

CONSOLIDATED BALANCE SHEETS FOR AVON PRODUCTS, INC., 2007–2008
(in millions, except per share data)

December 31	2008	2007
Assets		
Current assets		
Cash, including cash equivalents of $704.8 and $492.3	$ 1,104.7	$ 963.4
Accounts receivable (less allowances of $127.9 and $141.1)	687.8	795.0
Inventories	1,007.9	1,041.8
Prepaid expenses and other	756.5	715.2
Total current assets	3,556.9	3,515.4
Property, plant and equipment, at cost		
Land	85.3	71.8
Buildings and improvements	1,000.7	972.7
Equipment	1,353.9	1,317.9
	2,439.9	2,362.4
Less accumulated depreciation	(1,096.0)	(1,084.2)
	1,343.9	1,278.2
Other assets	1,173.2	922.6
Total assets	$ 6,074.0	$ 5,716.2
Liabilities and Shareholders' Equity		
Current liabilities		
Debt maturing within one year	$ 1,031.4	$ 929.5
Accounts payable	724.3	800.3
Accrued compensation	234.4	285.8
Other accrued liabilities	581.9	713.2
Sales and taxes other than income	212.2	222.3
Income taxes	128.0	102.3
Total current liabilities	2,912.2	3,053.4
Long-term debt	1,456.2	1,167.9
Employee benefit plans	665.4	388.7
Long-term income taxes	168.9	208.7
Other liabilities (including minority interest of $37.4 and $38.2)	196.4	185.9
Total liabilities	$ 5,399.1	$ 5,004.6
Commitments and contingencies (Notes 13 and 15)		
Shareholders'equity		
Common stock, par value $.25 – authorized 1,500 shares; issued 739.4 and 736.3 shares	$ 185.6	$ 184.7
Additional paid-in capital	1,874.1	1,724.6
Retained earnings	4,118.9	3,586.5
Accumulated other comprehensive loss	(965.9)	(417.0)
Treasury stock, at cost –313.1 and 308.6 shares	(4,537.8)	(4,367.2)
Total shareholders' equity	$ 674.9	$ 711.6
Total liabilities and shareholders' equity	$ 6,074.0	$ 5,716.2

Source: Avon Products, Inc. 2008, 10-K.

LO2 2. Review the information in Concepts & Connections 4.1 concerning the costs of the different value chain activities associated with recording and distributing music CDs through traditional brick-and-mortar retail outlets. Then answer the following questions:

a. Does the growing popularity of downloading music from the Internet give rise to a new music industry value chain that differs considerably from the traditional value chain? Explain why or why not.

b. What costs would be cut out of the traditional value chain or bypassed in the event recording studios sell downloadable files of artists' recordings direct to onlineb uyers?

c. What happens to the traditional value chain if more and more consumers use peer-to-peer file-sharing software to download music from the Internet rather than purchase CDs or downloadable files?

Exercises for Simulation Participants

LO1 LO2 LO3

1. What hard evidence can you cite that indicates your company's strategy is working fairly well (or perhaps not working so well, if your company'sp erformance is lagging that of rival companies)?
2. What resource strengths and resource weaknesses does your company have? What external market opportunities for growth and increased profitability exist for your company? What external threats to your company's future well-being and profitability do you and your co-managers see? What does the preceding SWOT analysis indicate about your company's present situation and future prospects—where on the scale from "exceptionally strong" to "alarmingly weak" does the attractiveness of your company'ss ituationr ank?
3. Does your company have any core competencies? If so, what are they?
4. What are the key elements of your company's value chain? Refer to Figure 4.1 in developing your answer.
5. Using the methodology presented in Table 4.2, prepare a competitive strength assessment for your company and two other companies that you and your co-managers consider to be very close competitors.

Chapter 5

The Five Generic Competitive Strategies

Chapter Learning Objectives

LO1. Gain an understanding of how each of the five generic competitive strategies go about building competitive advantage and delivering superior value to customers.

LO2. Recognize why some of the five generic strategies work better in certain kinds of industry and competitive conditions than in others.

LO3. Learn the major avenues for achieving a competitive advantage based on lower costs.

LO4. Learn the major avenues for developing a competitive advantage based on differentiating a company's product or service offering from the offerings of rivals.

There are several basic approaches to competing successfully and gaining a competitive advantage, but they all involve giving buyers what they perceive as superior value compared to the offerings of rival sellers. Superior value can mean offering a good product at a lower price, a superior product that is worth paying more for, or a best-value offering that represents an attractive combination of price, features, quality, service, and other appealing attributes.

This chapter describes the five *basic competitive strategy options* for building competitive advantage and delivering superior value to customers—which of the five to employ is a company's first and foremost choice in crafting an overall strategy and beginning its quest for competitive advantage.

Competitive Strategies and Industry Positioning

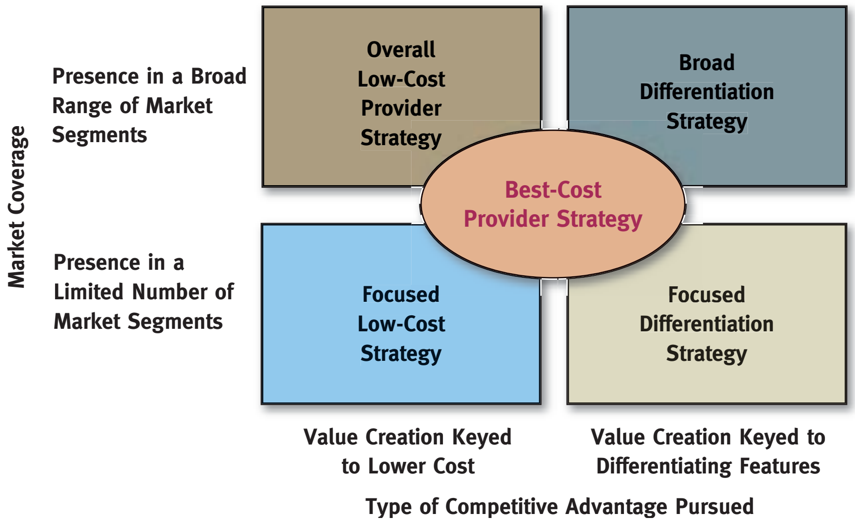
A company's **competitive strategy** *deals exclusively with the specifics of management's game plan for competing successfully—its specific efforts to please customers, its offensive and defensive moves to counter the maneuvers of rivals, its responses to whatever market conditions prevail at the moment, and its approach to securing a competitive advantage vis-à-vis rivals.* There are countless variations in the competitive strategies that companies employ, mainly because each company's strategic approach entails custom-designed actions to fit its own circumstances and industry environment. The custom-tailored nature of each company's strategy is also the result of management's efforts to uniquely position the company in its industry. Companies are much more likely to achieve competitive advantage and earn above-average profits if they are able to find a unique way of delivering superior value to customers. For example, the iPod's attractive styling, easy-to-use controls, attention-grabbing ads, and extensive collection of music available at Apple's iTunes Store has given Apple a competitive advantage in the digital music player industry. Microsoft has attempted to imitate Apple's competitive strategy with its introduction of its Zune music player and music store, but Microsoft has fared no better in its attack on the iPod than any of the other makers of MP3 players. By choosing a unique approach to providing value to customers, Apple has achieved an enduring brand loyalty that makes it difficult for others to triumph by merely copying its strategic approach. "Me too" strategies can rarely be expected to deliver competitive advantage and stellar performance unless the imitator possesses resources or competencies that allow it to provide greater value to customers than that offered by firms with similar strategic approaches.

A **competitive strategy** concerns the specifics of management's game plan for competing successfully and securing a competitive advantageov er rivals.

Competitive strategies that provide distinctive industry positioning and competitive advantage in the marketplace involve choosing between (1) a market target that is either broad or narrow, and (2) whether the company should pursue a competitive advantage linked to low costs or product differentiation. Figure 5.1 presents five proven competitive strategies keyed to

FIGURE 5.1 **The Five Generic Competitive Strategies**

Source: This is an author-expanded version of a 3-strategy classification discussed in Michael E. Porter, *Competitive Strategy* (New York: Free Press, 1980), pp. 35–40.



industry positioning.[1] The general approach to competing and operating the business is notably different for each of the five competitive strategies. The five generic strategies are:

1. *A low-cost provider strategy*—striving to achieve lower overall costs than rivals and appealing to a broad spectrum of customers, usually by under-pricingr ivals.
2. *A broad differentiation strategy*—seeking to differentiate the company's product or service from rivals' in ways that will appeal to a broad spectrum of buyers.
3. *A focused low-cost strategy*—concentrating on a narrow buyer segment (or market niche) and outcompeting rivals by having lower costs than rivals and thus being able to serve niche members at a lower price.
4. *A focused differentiation strategy*—concentrating on a narrow buyer segment (or market niche) and outcompeting rivals by offering niche members customized attributes that meet their tastes and requirements better than rivals' products.
5. *A best-cost provider strategy*—giving customers more value for the money by satisfying buyers' expectations on key quality/features/performance/service attributes while beating their price expectations. This option is a *hybrid* strategy that blends elements of low-cost provider and differentiation strategies; the aim is to have the lowest (best) costs and prices among sellers offering products with comparable differentiating attributes.

[1] This classification scheme is an adaptation of a narrower three-strategy classification presented in Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980), Chapter 2, especially pp. 35–40 and 44–46. For a discussion of the different ways that companies can position themselves in the marketplace, see Michael E. Porter, "What Is Strategy?" *Harvard Business Review* 74, no. 6 (November–December 1996), pp. 65–67.

Each of these five generic competitive approaches stakes out a different market position. The following sections explore the ins and outs of the five generic competitive strategies and how they differ.

Low-CostP rovider Strategies

Striving to be the industry's overall low-cost provider is a powerful competitive approach in markets with many price-sensitive buyers. A company achieves low-cost leadership when it becomes the industry's lowest-cost provider rather than just being one of perhaps several competitors with low costs. Successful low-cost providers boast meaningfully lower costs than rivals—but not necessarily the absolutely lowest possible cost. In striving for a cost advantage over rivals, managers must take care to include features and services that buyers consider essential—*a product offering that is too frills-free can be viewed by consumers as offering little value even if it is priced lower than competing products.*

A company has two options for translating a low-cost advantage over rivals into attractive profit performance. Option 1 is to use the lower-cost edge to underprice competitors and attract price-sensitive buyers in great enough numbers to increase total profits. Option 2 is to maintain the present price, be content with the present market share, and use the lower-cost edge to earn a higher profit margin on each unit sold, thereby raising the firm's total profits and overall return on investment.

AchievingL ow-CostLe adership

A low-cost edge over rivals is best accomplished in two ways: (1) performing essential value chain activities more cost-effectively than rivals and (2) revamping the firm's overall value chain to eliminate or bypass some cost-producing activities altogether.[2] Southwest Airlines has reconfigured the traditional value chain of commercial airlines to lower costs and thereby offer dramatically lower fares to passengers. Southwest does not offer in-flight meals, assigned seating, baggage transfer to connecting airlines, or first-class seating and service, thereby eliminating all the cost-producing activities associated with these features. The company's superior performance of essential activities also contributes to its cost advantage in the airline industry. Its mastery of fast turnarounds at the gates (about 25 minutes versus 45 minutes for rivals) allows its planes to fly more hours per day. This translates into being able to schedule more flights per day with fewer aircraft, allowing Southwest to generate more revenue per plane on average than rivals.

Success in achieving a low-cost edge over rivals comes from outmanaging rivals in performing essential activities and eliminating or curbing "nonessential" activities.

For a company to do a more cost-efficient job of managing its value chain than rivals, managers must launch a concerted, ongoing effort to ferret out cost-saving opportunities in every part of the value chain. No activity can escape cost-saving scrutiny and all avenues for performing value chain activities at a lower cost than rivals have to be explored. Normally, low-cost producers work diligently to create cost-conscious corporate cultures that feature

[2] Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), p. 97.

broad employee participation in continuous cost improvement efforts and limited perks and frills for executives. They strive to operate with exceptionally small corporate staffs to keep administrative costs to a minimum. Many successful low-cost leaders also use benchmarking to keep close tabs on how their costs compare with rivals and firms performing comparable activities in other industries.

But while low-cost providers are champions of frugality, they usually don't scrimp on investing in resources that promise to drive costs out of the business. Walmart, one of the foremost practitioners of low-cost leadership, has invested in state-of-the-art technology throughout its operations—its distribution facilities are an automated showcase, it uses online systems to order goods from suppliers and manage inventories, it equips its stores with cutting-edge sales-tracking and checkout systems, and it sends daily point-of-sale data to 4,000 vendors. Walmart's information and communications systems and capabilities are more sophisticated than those of virtually any other retail chain in the world. Concepts & Connections 5.1 describes Walmart's broad approach to managing its value chain in the retail grocery portion of its business to achieve a dramatic cost advantage over rival supermarket chains and become the world's biggest grocery retailer.

Market Conditions Favoring a Low-Cost Provider Strategy

A competitive strategy predicated on low-cost leadership is particularly powerful when:

1. *Price competition among rival sellers is especially vigorous*—Low-cost providers are in the best position to compete offensively on the basis of price and to survive price wars.
2. *The products of rival sellers are essentially identical and are readily available from several sellers*—Commoditylike products and/or ample supplies set the stage for lively price competition; in such markets, it is the less efficient, higher-cost companies that are most vulnerable.
3. *There are few ways to achieve product differentiation that have value to buyers*—When the product or service differences between brands do not matter much to buyers, buyers nearly always shop the market for the best price.
4. *Buyers incur low costs in switching their purchases from one seller to another*—Low switching costs give buyers the flexibility to shift purchases to lower-priced sellers having equally good products. A low-cost leader is well positioned to use low price to induce its customers not to switch to rival brands.
5. *The majority of industry sales are made to a few, large volume buyers*—Low-cost providers are in the best position among sellers in bargaining with high-volume buyers because they are able to beat rivals' pricing to land a high volume sale while maintaining an acceptable profit margin.
6. *Industry newcomers use introductory low prices to attract buyers and build a customer base*—The low-cost leader can use price cuts of its own to make it harder for a new rival to win customers.

Concepts & Connections 5.1

HOW WALMART MANAGED ITS VALUE CHAIN TO ACHIEVE A LOW-COST ADVANTAGE OVER RIVAL SUPERMARKET CHAINS

Walmart has achieved a very substantial cost and pricing advantage over rival supermarket chains by both revamping portions of the grocery retailing value chain and by outmanaging its rivals in efficiently performing various value chain activities. Its cost advantage stems from a series of initiatives and practices:

- Instituting extensive information sharing with vendors via online systems that relay sales at its checkout counters directly to suppliers of the items, thereby providing suppliers with real-time information on customer demand and preferences (creating an estimated 6 percent cost advantage).
- Pursuing global procurement of some items and centralizing most purchasing activities so as to leverage the company's buying power (creating an estimated 2.5 percent cost advantage).
- Investing in state-of-the-art automation at its distribution centers, efficiently operating a truck fleet that makes daily deliveries to Walmart's stores, and putting assorted other cost-saving practices into place at its headquarters, distribution centers, and stores (resulting in an estimated 4 percent cost advantage).
- Striving to optimize the product mix and achieve greater sales turnover (resulting in about a 2 percent cost advantage).
- Installing security systems and store operating procedures that lower shrinkage rates (producing a cost advantage of about 0.5 percent).
- Negotiating preferred real estate rental and leasing rates with real estate developers and owners of its store sites (yielding a cost advantage of 2 percent).
- Managing and compensating its workforce in a manner that produces lower labor costs (yielding an estimated 5 percent cost advantage)

Altogether, these value chain initiatives give Walmart an approximately 22 percent cost advantage over Kroger, Safeway, and other leading supermarket chains. With such a sizable cost advantage, Walmart has been able to underprice its rivals and become the world's leading supermarket retailer in little more than a decade.

Source: Developed by the authors from information at www.walmart.com and in Marco Iansiti and Roy Levien, "Strategy as Ecology," *Harvard Business Review* 82, no. 3 (March 2004), p. 70.

As a rule, the more price-sensitive buyers are, the more appealing a low-cost strategy becomes. A low-cost company's ability to set the industry's price floor and still earn a profit erects protective barriers around its market position.

The Hazards of a Low-Cost Provider Strategy

Perhaps the biggest pitfall of a low-cost provider strategy is getting carried away with *overly aggressive price cutting* and ending up with lower, rather than higher, profitability. A low-cost/low-price advantage results in superior profitability only if (1) prices are cut by less than the size of the cost advantage or (2) the added volume is large enough to bring in a bigger total profit despite lower margins per unit sold. Thus, a company with a 5 percent cost advantage cannot cut prices 20 percent, end up with a volume gain of only 10 percent, and still expect to earn higher profits!

A second big pitfall is *relying on an approach to reduce costs that can be easily copied by rivals.* The value of a cost advantage depends on its sustainability. Sustainability, in turn, hinges on whether the company achieves its cost advantage in ways difficult for rivals to replicate or match. If rivals find it relatively easy or inexpensive to imitate the leader's low-cost methods, then the leader's advantage will be too short-lived to yield a valuable edge in the marketplace.

A third pitfall is becoming *too fixated on cost reduction.* Low costs cannot be pursued so zealously that a firm's offering ends up being too features-poor to gain the interests of buyers. Furthermore, a company driving hard to push its costs down has to guard against misreading or ignoring increased buyer preferences for added features or declining buyer price sensitivity. Even if these mistakes are avoided, a low-cost competitive approach still carries risk. Cost-saving technological breakthroughs or process improvements can nullify a low-cost leader's hard-won position.

Broad Differentiation Strategies

The essence of a broad differentiation strategy is to be unique in ways that are valuable to a wide range of customers.

Differentiation strategies are attractive whenever buyers' needs and preferences are too diverse to be fully satisfied by a standardized product or service. A company attempting to succeed through differentiation must study buyers' needs and behavior carefully to learn what buyers think has value and what they are willing to pay for. Then the company must include these desirable features to clearly set itself apart from rivals lacking such product or service attributes.

Successful differentiation allows a firm to:

- Command a premium price, and/or
- Increase unit sales (because additional buyers are won over by the differentiating features),an d/or
- Gain buyer loyalty to its brand (because some buyers are strongly attracted to the differentiating features and bond with the company and its products).

Differentiation enhances profitability whenever the extra price the product commands outweighs the added costs of achieving the differentiation. Company differentiation strategies fail when buyers don't value the brand's uniqueness and/or when a company's approach to differentiation is easily copied or matched by its rivals.

Approachest oD ifferentiation

Companies can pursue differentiation from many angles: a unique taste (Dr Pepper, Listerine); multiple features (Microsoft Windows 7, Microsoft Office); wide selection and one-stop shopping (Home Depot, Amazon.com); superior service (FedEx); spare parts availability (Caterpillar guarantees 48-hour spare parts delivery to any customer anywhere in the world or else the part is furnished free); engineering design and performance (Mercedes, BMW); prestige and distinctiveness (Rolex); product reliability (Whirlpool and GE in large home appliances); quality manufacturing (Michelin in tires, Toyota and Honda in automobiles); technological leadership (3M Corporation in bonding and coating products); a full range of services (Charles Schwab in stock brokerage); a complete line of products (Campbell's soups); and top-of-the-line image and reputation (Ralph Lauren and Starbucks).

The most appealing approaches to differentiation are those that are hard or expensive for rivals to duplicate. Indeed, resourceful competitors can, in time, clone almost any product or feature or attribute. If Coca-Cola introduces a vitamin-enhanced bottled water, so can Pepsi; if Canon introduces 12 megapixel camera, so can Sony and Nikon; if Research in Motion (the maker of the popular Blackberry models) introduces e-mail enabled mobile phones, so can Samsung, Apple, and LG. As a rule, differentiation yields a longer-lasting and more profitable competitive edge when it is based on product innovation, technical superiority, product quality and reliability, comprehensive customer service, and unique competitive capabilities. Such differentiating attributes tend to be tough for rivals to copy or offset profitably and buyers widely perceive them as having value.

Easy-to-copy differentiating features cannot produce sustainable competitive advantage; differentiation based on hard-to-copy competencies and capabilities tends to be more sustainable.

Creating Value for Customers through Differentiation

While it is easy enough to grasp that a successful differentiation strategy must offer value in ways unmatched by rivals, a big issue in crafting a differentiation strategy is deciding what is valuable to customers. Typically, value can be delivered to customers in four basic ways.

1. *Include product attributes and user features that lower the buyer's costs.* Commercial buyers value products that can reduce their cost of doing business. For example, making a company's product more economical for a buyer to use can be done by reducing the buyer's raw materials waste (providing cut-to-size components), reducing a buyer's inventory requirements (providing just-in-time deliveries), increasing product reliability to lower a buyer's repair and maintenance costs, and providing free technical support. Similarly, consumers find value in differentiating features that will reduce their expenses. Rising costs for gasoline prices have spurred the efforts of motor vehicle manufacturers worldwide to introduce models with better fuel economy.
2. *Incorporate features that improve product performance.*[3] Commercial buyers and consumers alike value higher levels of performance in many types of products. Product reliability, output, durability, convenience, and ease of use are aspects of product performance that differentiate products offered to buyers. Mobile phone manufacturers are currently in a race to improve the performance of their products through the introduction of next-generation phones with a more appealing, trend-setting set of user features and options.
3. *Incorporate features that enhance buyer satisfaction in noneconomic or intangible ways.* Toyota's Prius appeals to environmentally conscious motorists who wish to help reduce global carbon dioxide emissions. Bentley, Ralph Lauren,

[3] Ibid., pp. 135–138.

Louis Vuitton, Tiffany, Cartier, and Rolex have differentiation-based competitive advantages linked to buyer desires for status, image, prestige, upscale fashion, superior craftsmanship, and the finer things in life. L.L. Bean makes its mail-order customers feel secure in their purchases by providing an unconditional guarantee with no time limit.

4. *Deliver value to customers by exploiting competencies and competitive capabilities that rivals don't have or can't afford to match.*[4] Core and/or distinctive competencies that are unique in the industry can be used to help set a company apart from its rivals. There are numerous examples of companies that have differentiated themselves on the basis of capabilities. Nintendo is able to offer Wii owners a large selection of fun-for-all-ages games because of the strength of its internal game development operations and its extensive network of third-party game developers. Japanese automakers can adapt faster to changing consumer preferences for one vehicle style versus another because they have the capabilities to bring new models to market faster than American and European automakers.

Where to Look for Opportunities to Differentiate

Differentiation is not necessarily something hatched in marketing and advertising departments, nor is it limited to quality and service. Differentiation opportunities can exist in all activities that affect the value of a product or service; possibilities include the following:

- *Supply chain activities* that ultimately spill over to affect the performance or quality of the company's end product. Starbucks gets high ratings on its coffees partly because it has very strict specifications on the coffee beans purchased from suppliers.
- *Product R&D activities* that aim at improved product designs and performance, expanded end uses and applications, more frequent first-to-market victories, added user safety, greater recycling capability, or enhanced environmental protection.
- *Production R&D and technology-related activities* that permit the manufacture of customized products at an efficient cost; make production methods safer for the environment; or improve product quality, reliability, and appearance. Many manufacturers have developed flexible manufacturing systems that allow different models and product versions to be made on the same assembly line. Being able to provide buyers with made-to-order products can be a potent differentiating capability.
- *Manufacturing activities* that reduce product defects, extend product life, allow better warranty coverages, or enhance product appearance. The quality edge enjoyed by Japanese automakers stems partly from their distinctive competence in performing assembly line activities.

[4] For a more detailed discussion, see George Stalk, Philip Evans, and Lawrence E. Schulman, "Competing on Capabilities: The New Rules of Corporate Strategy," *Harvard Business Review* 70, no. 2 (March–April 1992), pp. 57–69.

- *Distribution and shipping activities* that allow for fewer warehouse and on-the-shelf stockouts, quicker delivery to customers, more accurate order filling, and/or lower shipping costs.
- *Marketing, sales, and customer service activities* that result in superior technical assistance to buyers, faster maintenance and repair services, better credit terms, quicker order processing, or greater customer convenience.

Perceived Value and the Importance of Signaling Value

The price premium commanded by a differentiation strategy reflects *the value actually delivered* to the buyer and *the value perceived* by the buyer. The value of certain differentiating features is rather easy for buyers to detect, but in some instances buyers may have trouble assessing what their experience with the product will be.[5] Successful differentiators go to great lengths to make buyers knowledgeable about a product's value and incorporate signals of value such as attractive packaging, extensive ad campaigns, the quality of brochures and sales presentations, the seller's list of customers, the length of time the firm has been in business, and the professionalism, appearance, and personality of the seller's employees. Such signals of value may be as important as actual value (1) when the nature of differentiation is subjective or hard to quantify, (2) when buyers are making a first-time purchase, (3) when repurchase is infrequent, and (4) when buyers are unsophisticated.

Market Conditions Favoring a Differentiation Strategy

Differentiation strategies tend to work best in market circumstances where:

1. *Buyer needs and uses of the product are diverse*—Diverse buyer preferences allow industry rivals to set themselves apart with product attributes that appeal to particular buyers. For instance, the diversity of consumer preferences for menu selection, ambience, pricing, and customer service gives restaurants exceptionally wide latitude in creating differentiated concepts. Other industries offering opportunities for differentiation based upon diverse buyer needs and uses include magazine publishing, automobile manufacturing, footwear, kitchen appliances, and computers.
2. *There are many ways to differentiate the product or service that have value to buyers*—Industries that allow competitors to add features to product attributes are well suited to differentiation strategies. For example, hotel chains can differentiate on such features as location, size of room, range of guest services, in-hotel dining, and the quality and luxuriousness of bedding and furnishings. Similarly, cosmetics producers are able to differentiate based upon prestige and image, formulations that fight the signs of aging, UV light protection, exclusivity of retail locations, the inclusion of antioxidants and natural ingredients, or prohibitions against animal testing.

[5] The relevance of perceived value and signaling is discussed in more detail in Porter, *Competitive Advantage: Creating and Sustaining Superior Performance*, (New York: Simon & Schuster, 1996), pp. 138–142.

3. *Few rival firms are following a similar differentiation approach*—The best differentiation approaches involve trying to appeal to buyers on the basis of attributes that rivals are not emphasizing. A differentiator encounters less head-to-head rivalry when it goes its own separate way to create uniqueness and does not try to outdifferentiate rivals on the very same attributes. When many rivals are all claiming "ours tastes better than theirs" or "ours gets your clothes cleaner than theirs," competitors tend to end up chasing the same buyers with very similar product offerings.
4. *Technological change is fast-paced and competition revolves around rapidly evolving product features*—Rapid product innovation and frequent introductions of next-version products heighten buyer interest and provide space for companies to pursue distinct differentiating paths. In video game hardware and video games, golf equipment, PCs, mobile phones, and automobile navigation systems, competitors are locked into an ongoing battle to set themselves apart by introducing the best next-generation products—companies that fail to come up with new and improved products and distinctive performance features quickly lose out in the marketplace.

The Hazards of a Differentiation Strategy

Differentiation strategies can fail for any of several reasons. *A differentiation strategy keyed to product or service attributes that are easily and quickly copied is always suspect.* Rapid imitation means that no rival achieves meaningful differentiation, because whatever new feature one firm introduces that strikes the fancy of buyers is almost immediately added by rivals. This is why a firm must search out sources of uniqueness that are time-consuming or burdensome for rivals to match if it hopes to use differentiation to win a sustainable competitive edge over rivals.

Differentiation strategies can also falter when buyers see little value in the unique attributes of a company's product. Thus even if a company sets the attributes of its brand apart from its rivals' brands, its strategy can fail because of trying to differentiate on the basis of something that does not deliver adequate value to buyers. Any time many potential buyers look at a company's differentiated product offering and conclude "so what," the company's differentiation strategy is in deep trouble—buyers will likely decide the product is not worth the extra price and sales will be disappointingly low.

Overspending on efforts to differentiate is a strategy flaw that can end up eroding profitability. Company efforts to achieve differentiation nearly always raise costs. The trick to profitable differentiation is either to keep the costs of achieving differentiation below the price premium the differentiating attributes can command in the marketplace or to offset thinner profit margins by selling enough additional units to increase total profits. If a company goes overboard in pursuing costly differentiation, it could be saddled with unacceptably thin profit margins or even losses. The need to contain differentiation costs is why many companies add little touches of differentiation that add to buyer satisfaction but are inexpensive to institute.

Other common pitfalls and mistakes in crafting a differentiation strategy include:[6]

- *Overdifferentiating so that product quality or service levels exceed buyers' needs.* Buyers are unlikely to pay extra for features and attributes that will go unused. For example, video game users are unlikely to purchase game consoles featuring high-resolution graphics and broadband connectivity if they don't own an HDTV and subscribe to an Internet service.
- *Trying to charge too high a price premium.* Even if buyers view certain extras or deluxe features as "nice to have," they may still conclude that the added benefit or luxury is not worth the price differential over that of lesser differentiated products.
- *Being timid and not striving to open up meaningful gaps in quality or service or performance features vis-à-vis the products of rivals*—tiny differences between rivals' product offerings may not be visible or important to buyers.

A low-cost provider strategy can always defeat a differentiation strategy when buyers are satisfied with a basic product and don't think "extra" attributes are worth a higher price.

Focused (or Market Niche) Strategies

What sets focused strategies apart from low-cost leadership or broad differentiation strategies is a concentration on a narrow piece of the total market. The targeted segment, or niche, can be defined by geographic uniqueness or by special product attributes that appeal only to niche members. The advantages of focusing a company's entire competitive effort on a single market niche are considerable, especially for smaller and medium-sized companies that may lack the breadth and depth of resources to tackle going after a national customer base with a "something for everyone" lineup of models, styles, and product selection. Community Coffee, the largest family-owned specialty coffee retailer in the United States, has a geographic focus on the state of Louisiana and communities across the Gulf of Mexico. Community holds only a 1.1 percent share of the national coffee market, but has recorded sales in excess of $100 million and has won a 50 percent share of the coffee business in the 11-state region where it is distributed. Examples of firms that concentrate on a well-defined market niche keyed to a particular product or buyer segment include Animal Planet and the History Channel (in cable TV); Google (in Internet search engines); Porsche (in sports cars); and Bandag (a specialist in truck tire recapping that promotes its recaps aggressively at over 1,000 truck stops). Microbreweries, local bakeries, bed-and-breakfast inns, and local owner-managed retail boutiques are all good examples of enterprises that have scaled their operations to serve narrow or local customer segments.

AF ocusedLo w-CostS trategy

A focused strategy based on low cost aims at securing a competitive advantage by serving buyers in the target market niche at a lower cost and a lower

[6] Porter, *Competitive Advantage*, pp. 160–162.

price than rival competitors. This strategy has considerable attraction when a firm can lower costs significantly by limiting its customer base to a well-defined buyer segment. The avenues to achieving a cost advantage over rivals also serving the target market niche are the same as for low-cost leadership—outmanage rivals in keeping the costs to a bare minimum and searching for innovative ways to bypass or reduce nonessential activities. The only real difference between a low-cost provider strategy and a focused low-cost strategy is the size of the buyer group to which a company is appealing.

Focused low-cost strategies are fairly common. Producers of private-label goods are able to achieve low costs in product development, marketing, distribution, and advertising by concentrating on making generic items similar to name-brand merchandise and selling directly to retail chains wanting a low-priced store brand. The Perrigo Company has become a leading manufacturer of over-the-counter health care products with 2008 sales of more than $1.8 billion by focusing on producing private-label brands for retailers such as Walmart, CVS, Walgreens, Rite Aid, and Safeway. Even though Perrigo doesn't make branded products, a focused low-cost strategy is appropriate for the makers of branded products as well. Concepts & Connections 5.2 describes how Vizio's low costs and focus on big box retailers has allowed it to become the largest seller of flat panel HDTVs in the United States within six years of its start-up.

A Focused Differentiation Strategy

Focused differentiation strategies are keyed to offering carefully designed products or services to appeal to the unique preferences and needs of a narrow, well-defined group of buyers (as opposed to a broad differentiation strategy aimed at many buyer groups and market segments). Companies like Four Seasons Hotels and Resorts, Chanel, Gucci, and Louis Vuitton employ successful differentiation-based focused strategies targeted at affluent buyers wanting products and services with worldclass attributes. Indeed, most markets contain a buyer segment willing to pay a price premium for the very finest items available, thus opening the strategic window for some competitors to pursue differentiation-based focused strategies aimed at the very top of the market pyramid. Ferrari markets its 1,500 cars sold in North America each year to a list of just 20,000 highly affluent car enthusiasts. Only the highest echelon of this exclusive group were contacted by Ferrari for a chance to put their names on the waiting list for one of the 20 $1.1 million FXX models planned for sale in North America. Concepts & Connections 5.3 describes Progressive Insurance's focused differentiation strategy.

Conditions Making a Focused Low-Cost or Focused Differentiation Strategy Viable

A focused strategy aimed at securing a competitive edge based either on low cost or differentiation becomes increasingly attractive as more of the following conditions are met:

- The target market niche is big enough to be profitable and offers good growthp otential.

Concepts & Connections 5.2

VIZIO'S FOCUSED LOW-COST STRATEGY

California-based Vizio, Inc., designs flat panel LCD and Plasma TVs ranging in size from 20 inches to 55 inches, which are sold only by big box discount retailers such as Walmart, Sam's Club, Costco Wholesale, and Best Buy. If you've shopped for a flat panel TV recently, you've probably noticed that Vizio is among the lowest-priced brands and that its picture quality is surprisingly good considering the price. The company is able to keep its cost low by only designing TVs and then sourcing production to a limited number of contract manufacturers in Taiwan. In fact, 80 percent of its production is handled by AmTran Technology. Such a dependence on a supplier can place a buyer in a precarious situation by making it vulnerable to price increases or product shortages, but Vizio has countered this possible threat by making AmTran a major stockholder. AmTran Technology owns a 23 percent stake in Vizio and earns about 80 percent of its revenues from its sales of televisions to Vizio. This close relationship with its major supplier and its focus on a single product category sold through limited distribution channels allows Vizio to offer its customers deep price discounts.

Vizio's first major account was landed in 2003 when it approached Costco buyers with a 46-inch plasma TV with a wholesale price that was half the price of the next-lowest-price competitor. Within two months, Costco was carrying Vizio flat screen TVs in 320 of its warehouse stores in the United States. In October 2007, Vizio approached buyers for Sam's Club with a 20-inch LCD TV that could be sold at retail for under $350. The price and quality of the 20-inch TV led Sam's Club buyers to place an order for 20,000 TVs for a March 2008 delivery. In 2009, Vizio was the largest seller of flat panel HDTVs in the United States with a market share of 21.6 percent. Vizio recorded revenues of $2 billion in 2007 and it was the industry's most profitable seller of TVs.

Source: Vizio's rapid success was highlighted in "Picture Shift: U.S. Upstart Takes On TV Giants in Price War," *The Wall Street Journal,* April 15, 2008, p. A1; and "Vizio Achieves #1 LCD HDTV Ranking in North America and #1 Ranking in U.S. Flat Panel HDTV Shipments," Vizio Press Release, May 11, 2009.

- Industry leaders have chosen not to compete in the niche—in which case focusers can avoid battling head-to-head against the industry's biggest and strongestc ompetitors.
- It is costly or difficult for multisegment competitors to meet the specialized needs of niche buyers and at the same time satisfy the expectations of mainstreamc ustomers.
- The industry has many different niches and segments, thereby allowing a focuser to pick a niche suited to its resource strengths and capabilities.
- Few, if any, rivals are attempting to specialize in the same target segment.

The Hazards of a Focused Low-Cost or Focused Differentiation Strategy

Focusing carries several risks. The *first major risk* is the chance that competitors will find effective ways to match the focused firm's capabilities in serving the target niche. In the lodging business, large chains like Marriott and Hilton have launched multibrand strategies that allow them to compete effectively in several lodging segments simultaneously. Marriott has flagship hotels with a full complement of services and amenities that allow it to attract travelers and

Concepts & Connections 5.3

PROGRESSIVE INSURANCE'S FOCUSED DIFFERENTIATION STRATEGY IN AUTO INSURANCE

Progressive Insurance has fashioned a strategy in auto insurance focused on people with a record of traffic violations who drive high-performance cars, drivers with accident histories, motorcyclists, teenagers, and other so-called high-risk categories of drivers that most auto insurance companies steer away from. Progressive discovered that some of these high-risk drivers are affluent and pressed for time, making them less sensitive to paying premium rates for their car insurance. Management learned that it could charge such drivers high enough premiums to cover the added risks, plus it differentiated Progressive from other insurers by expediting the process of obtaining insurance and decreasing the annoyance that such drivers faced in obtaining insurance coverage. Progressive pioneered the low-cost direct sales model of allowing customers to purchase insurance online and over the phone.

Progressive also studied the market segments for insurance carefully enough to discover that some motorcycle owners were not especially risky (middle-aged suburbanites who sometimes commuted to work or used their motorcycles mainly for recreational trips with their friends). Progressive's strategy allowed it to become a leader in the market for luxury-car insurance for customers who appreciated Progressive's streamlined approach to doing business.

In further differentiating and promoting Progressive policies, management created teams of roving claims adjusters who would arrive at accident scenes to assess claims and issue checks for repairs on the spot. Progressive introduced 24-hour claims reporting, now an industry standard. In addition, it developed a sophisticated pricing system so that it could quickly and accurately asses each customer's risk and weed out unprofitable customers.

By being creative and excelling at the nuts and bolts of its business, Progressive has won a 7.6 percent share of the $150 billion market for auto insurance and has the highest underwriting margins in the auto-insurance industry.

Sources: www.progressiveinsurance.com; Ian C. McMillan, Alexander van Putten, and Rita Gunther McGrath, "Global Gamesmanship," *Harvard Business Review* 81, no. 5 (May 2003), p. 68; *Fortune*, May 16, 2005, p. 34; and "Motorcyclists Age, Affluence Trending Upward," *BestWire*, July 24, 2007.

vacationers going to major resorts; it has J.W. Marriott and Ritz-Carlton hotels that provide deluxe comfort and service to business and leisure travelers; it has Courtyard by Marriott and SpringHill Suites brands for business travelers looking for moderately priced lodging; it has Marriott Residence Inns and TownePlace Suites designed as a "home away from home" for travelers staying five or more nights; and it has more than 590 Fairfield Inn locations that cater to travelers looking for quality lodging at an "affordable" price. Similarly, Hilton has a lineup of brands (Waldorf Astoria, Conrad Hotels, Doubletree Hotels, Embassy Suites Hotels, Hampton Inns, Hilton Hotels, Hilton Garden Inns, and Homewood Suites) that enable it to compete in multiple segments and compete head-to-head against lodging chains that operate only in a single segment. Multibrand strategies are attractive to large companies like Marriott and Hilton precisely because they enable a company to enter a market niche and siphon business away from companies that employ a focus strategy.

A *second risk* of employing a focus strategy is the potential for the preferences and needs of niche members to shift over time toward the product attributes desired by the majority of buyers. An erosion of the differences across buyer segments lowers entry barriers into a focuser's market niche and provides an open invitation for rivals in adjacent segments to begin competing for the focuser's customers. A *third risk* is that the segment may become so attractive it is soon inundated with competitors, intensifying rivalry and splintering segment profits.

Best-CostP rovider Strategies

As Figure5.1 indicates, **best-cost provider strategies** stake out a middle ground between pursuing a low-cost advantage and a differentiation advantage and between appealing to the broad market as a whole and a narrow market niche. Such a middle ground allows a company to aim squarely at the sometimes great mass of value-conscious buyers looking for a good-to-very-good product or service at an economical price. Value-conscious buyers frequently shy away from both cheap low-end products and very expensive high-end products, but they are quite willing to pay a "fair" price for extra features and functionality they find appealing and useful. The essence of a best-cost provider strategy is giving customers *more value for the money* by satisfying buyer desires for appealing features/performance/quality/service and charging a lower price for these attributes compared to rivals with similar caliber product offerings.[7]

Best-cost provider strategies are a *hybrid* of low-cost provider and differentiation strategies that aim at satisfying buyer expectations on key quality/features/performance/service attributes and beating customer expectations on price.

To profitably employ a best-cost provider strategy, a company *must have the capability to incorporate attractive or upscale attributes at a lower cost than rivals.* This capability is contingent on (1) a superior value chain configuration that eliminates or minimizes activities that do not add value, (2) unmatched efficiency in managing essential value chain activities, and (3) resource strengths and core competencies that allow differentiating attributes to be incorporated at a low cost. When a company can incorporate appealing features, good-to-excellent product performance or quality, or more satisfying customer service into its product offering *at a lower cost than rivals,* then it enjoys "best cost" status—it is the low-cost provider of a product or service with *upscale attributes.* A best-cost provider can use its low-cost advantage to underprice rivals whose products or services have similar upscale attributes and still earn attractive profits.

Concepts & Connections 5.4 describes how Toyota has applied the principles of a best-cost provider strategy in producing and marketing its Lexus brand.

The Danger of an Unsound Best-Cost Provider Strategy

A company's biggest vulnerability in employing a best-cost provider strategy is not having the requisite core competencies and efficiencies in managing value chain activities to support the addition of differentiating features

[7] For an excellent discussion of best-cost provider strategies, see Peter J. Williamson and Ming Zeng, "Value-for-Money Strategies for Recessionary Times," *Harvard Business Review* 87, no. 3 (March 2009), pp. 66–74.

Concepts & Connections 5.4

TOYOTA'S BEST-COST PRODUCER STRATEGY FOR ITS LEXUS LINE

Toyota Motor Company is widely regarded as a low-cost producer among the world's motor vehicle manufacturers. Despite its emphasis on product quality, Toyota has achieved low-cost leadership because it has developed considerable skills in efficient supply chain management and low-cost assembly capabilities, and because its models are positioned in the low-to-medium end of the price spectrum, where high production volumes are conducive to low unit costs. But when Toyota decided to introduce its new Lexus models to compete in the luxury-car market, it employed a classic best-cost provider strategy. Toyota took the following four steps in crafting and implementing its Lexus strategy:

- Designing an array of high-performance characteristics and upscale features into the Lexus models so as to make them comparable in performance and luxury to other high-end models and attractive to Mercedes, BMW, Audi, Jaguar, Cadillac, and Lincoln buyers.
- Transferring its capabilities in making high-quality Toyota models at low cost to making premium-quality Lexus models at costs below other luxury-car makers. Toyota's supply chain capabilities and low-cost assembly know-how allowed it to incorporate high-tech performance features and upscale quality into Lexus models at substantially less cost than comparable Mercedes and BMW models.
- Using its relatively lower manufacturing costs to underprice comparable Mercedes and BMW models. Toyota believed that with its cost advantage it could price attractively equipped Lexus cars low enough to draw price-conscious buyers away from Mercedes and BMW. Toyota's pricing policy also allowed it to induce Toyota, Honda, Ford, or GM owners desiring more luxury to switch to a Lexus. Lexus's pricing advantage over Mercedes and BMW was sometimes quite significant. For example, in 2009 the Lexus RX 350, a mid-sized SUV, carried a sticker price in the $36,000–$48,000 range (depending on how it was equipped), whereas variously equipped Mercedes ML 350 SUVs had price tags in the $44,000–$90,000 range and a BMW X5 SUV could range anywhere from $47,500 to $86,000, depending on the optional equipment chosen.
- Establishing a new network of Lexus dealers, separate from Toyota dealers, dedicated to providing a level of personalized, attentive customer service unmatched in the industry.

Lexus' best-cost strategy allowed it to become the number-one-selling luxury car brand worldwide in 2000—a distinction it has held through 2008.

without significantly increasing costs. A company with a modest degree of differentiation and no real cost advantage will most likely find itself squeezed between the firms using low-cost strategies and those using differentiation strategies. Low-cost providers may be able to siphon customers away with the appeal of a lower price (despite having marginally less appealing product attributes). High-end differentiators may be able to steal customers away with the appeal of appreciably better product attributes (even though their products carry a somewhat higher price tag). Thus, a successful best-cost provider must offer buyers *significantly* better product attributes in order to justify a price above what low-cost leaders are charging. Likewise, it has to achieve significantly lower costs in providing upscale features so that it can outcompete high-end differentiators on the basis of a *significantly* lower price.

The Peril of Adopting a "Stuck in the Middle" Strategy

Each of the five generic competitive strategies positions the company differently in its market and competitive environment. Each establishes a central theme for how the company will endeavor to outcompete rivals. Each creates some boundaries or guidelines for maneuvering as market circumstances unfold and as ideas for improving the strategy are debated. Thus, settling on which generic strategy to employ is perhaps the most important strategic commitment a company makes—it tends to drive the rest of a company's strategic actions.

One of the big dangers in crafting a competitive strategy is that managers, torn between the pros and cons of the various generic strategies, will opt for *"stuck in the middle"* strategies that represent compromises between lower costs and greater differentiation and between broad and narrow market appeal. Compromise or middle-ground strategies rarely produce sustainable competitive advantage or a distinctive competitive position. Usually, companies with compromise strategies end up with a middle-of-the-pack industry ranking—they have average costs, some but not a lot of product differentiation relative to rivals, an average image and reputation, and little prospect of industry leadership.

Successful Competitive Strategies Are Well-Matched to a Company's Resources and Capabilities

For a positioning-based competitive strategy to succeed in delivering good performance and the intended competitive edge over rivals, it has to be well-matched to a company's internal situation and underpinned by an appropriate set of resources, know-how, and competitive capabilities. To succeed in employing a low-cost provider strategy, a company has to have the resource strengths and capabilities to keep its costs below those of its competitors; this means having the expertise to cost-effectively manage value chain activities better than rivals and/or the innovative capability to bypass certain value chain activities being performed by rivals. To succeed in strongly differentiating its product in ways that are appealing to buyers, a company must have the resource capabilities (like better technology, strong skills in product innovation, expertise in customer service) to incorporate unique attributes into its product offering that a broad range of buyers will find appealing and worth paying for. Strategies focusing on a narrow segment of the market require the capability to do an outstanding job of satisfying the needs and expectations of niche buyers. Success in employing a strategy keyed to a best-value offering requires the resource capabilities to incorporate upscale product or service attributes at a lower cost than rivals.

A company's positioning-based competitive strategy should be well-matched to its internal situation and predicated on leveraging competitively valuable resource strengths and core competencies.

KeyP oints

1. Early in the process of crafting a strategy, company managers have to decide which of the five basic competitive strategies to employ—overall low-cost, broad differentiation, focused low-cost, focused differentiation, or best-cost provider.
2. In employing a low-cost provider strategy, a company must do a better job than rivals of cost-effectively managing internal activities and/or it must find innovative ways to eliminate or bypass cost-producing activities. Low-cost provider strategies work particularly well when price competition is strong and the products of rival sellers are very weakly differentiated. Other conditions favoring a low-cost provider strategy are when supplies are readily available from eager sellers, when there are not many ways to differentiate that have value to buyers, when the majority of industry sales are made to a few large buyers, when buyer switching costs are low, and when industry newcomers are likely to use a low introductory price to build market share.
3. Broad differentiation strategies seek to produce a competitive edge by incorporating attributes and features that set a company's product/service offering apart from rivals in ways that buyers consider valuable and worth paying for. Successful differentiation allows a firm to (1) command a premium price for its product, (2) increase unit sales (because additional buyers are won over by the differentiating features), and/or (3) gain buyer loyalty to its brand (because some buyers are strongly attracted to the differentiating features and bond with the company and its products). Differentiation strategies work best in markets with diverse buyer preferences where there are big windows of opportunity to strongly differentiate a company's product offering from those of rival brands, in situations where few other rivals are pursuing a similar differentiation approach, and in circumstances where technological change is fast-paced and competition centers on rapidly evolving product features. A differentiation strategy is doomed when competitors are able to quickly copy most or all of the appealing product attributes a company comes up with, when a company's differentiation efforts meet with a ho-hum or so-what market reception, or when a company erodes profitability by overspending on efforts to differentiate its product offering.
4. A focus strategy delivers competitive advantage either by achieving lower costs than rivals in serving buyers comprising the target market niche or by offering niche buyers an appealingly differentiated product or service that meets their needs better than rival brands. A focused strategy becomes increasingly attractive when the target market niche is big enough to be profitable and offers good growth potential, when it is costly or difficult for multisegment competitors to put capabilities in place to meet the specialized needs of the target market niche and at the same time satisfy the expectations of their mainstream customers, when there are one or more niches that present a good match with a focuser's resource strengths and capabilities, and when few other rivals are attempting to specialize in the same target segment.
5. Best-cost provider strategies stake out a middle ground between pursuing a low-cost advantage and a differentiation-based advantage and between appealing to the broad market as a whole and a narrow market niche. The aim is to create competitive advantage by giving buyers more value for the money—satisfying buyer expectations on key quality/features/performance/service attributes while beating customer expectations on price. To profitably employ a best-cost

provider strategy, a company *must have the capability to incorporate attractive or upscale attributes at a lower cost than rivals.* This capability is contingent on (1) a superior value chain configuration, (2) unmatched efficiency in managing essential value chain activities, and (3) resource strengths and core competencies that allow differentiating attributes to be incorporated at a low cost. A best-cost provider strategy works best in markets where opportunities to differentiate exist and where many buyers are sensitive to price and value.

6. Deciding which generic strategy to employ is perhaps the most important strategic commitment a company makes—it tends to drive the rest of the strategic actions a company decides to undertake and it sets the whole tone for the pursuit of a competitive advantage over rivals.

Assurance of Learning Exercises

LO1
LO3
LO4

1. Best Buy is the largest consumer electronics retailer in the United States with 2009 sales of more than $45 billion. The company competes aggressively on price with rivals such as Costco Wholesale, Sam's Club, Walmart, and Target, but is also known by consumers for its first-rate customer service. Best Buy customers have commented that the retailer's sales staff is exceptionally knowledgeable about the products they sell and can direct them to the exact location of difficult to find items. Best Buy customers also appreciate that demonstration models of PC monitors, MP3 players, and other electronics are fully powered and ready for in-store use. Best Buy's Geek Squad tech support and installation services are additional customer service features that are valued by many customers.

   How would you characterize Best Buy's competitive strategy? Should it be classified as a low-cost provider strategy? a differentiation strategy? a best-cost strategy? Explain your answer.

LO1
LO4

2. Explore BMW's Web site at www.bmwgroup.com and see if you can identify at least three ways in which the company seeks to differentiate itself from rival automakers. Is there reason to believe that BMW's differentiation strategy has been successful in producing a competitive advantage? Why or why not?

Exercises for Simulation Participants

LO1

1. Whicho neo ft hefi ve generic competitive strategies best characterize your company's strategic approach to competing successfully?
2. Which rival companies appear to be employing a low-cost provider strategy?
3. Which rival companies appear to be employing a broad differentiation strategy?
4. Which rival companies appear to be employing a best-cost provider strategy?
5. Which rival companies appear to be employing some type of focus strategy?

Chapter 6

Supplementing the Chosen Competitive Strategy—Other Important Business Strategy Choices

Chapter Learning Objectives

LO1. Gain an understanding of how strategic alliances and collaborative partnerships can bolster a company's competitive capabilities and resource strengths.

LO2. Become aware of the strategic benefits of mergers and acquisitions.

LO3. Understand when a company should consider using a vertical integration strategy to extend its operations to more stages of the overall industry value chain.

LO4. Understand the conditions that favor farming out certain value chain activities to outside vendors and strategic allies.

LO5. Learn whether and when to pursue offensive strategic moves to improve a company's market position.

LO6. Learn whether and when to employ defensive strategies to protect the company's market position.

LO7. Recognize when being a first-mover or a fast-follower or a late-mover can lead to competitive advantage.

Once a company has settled on which of the five basic competitive strategies to employ, attention turns to what *other strategic actions* it can take to complement its competitive approach and round out its business strategy. As discussed in earlier chapters, a company's overall business strategy includes not only the details of its competitive strategy to deliver value to customers in a unique way, but also any other strategic initiatives that can promote competitive advantage. Several measures to enhance a company's strategy have to be considered:

- Whether to enter into strategic alliances or partnership arrangements with othere nterprises.
- Whether to bolster the company's market position via merger or acquisitions.
- Whether to integrate backward or forward into more stages of the industry value chain.
- Which value chain activities, if any, should be outsourced.
- Whether and when to go on the offensive and initiate aggressive strategic moves to improve the company's market position.
- Whether and when to employ defensive strategies to protect the company's market position.
- When to undertake strategic moves—whether it is advantageous to be a first-mover or a fast follower or a late-mover.

This chapter presents the pros and cons of each of these business strategy choices.

Strategic Alliances and Collaborative Partnerships

Companies in all types of industries have elected to form strategic alliances and partnerships to add to their accumulation of resources and competitive capabilities and strengthen their competitiveness in domestic and international markets. Strategic alliances allow companies to correct particular resource gaps or deficiencies by partnering with other enterprises having the missing know-how and capabilities. Thus, *a* **strategic alliance** *is a formal agreement between two or more separate companies in which there is strategically relevant collaboration of some sort, joint contribution of resources, shared risk, shared control, and mutual dependence.* Collaborative relationships between partners may entail a contractual agreement but they commonly stop short of formal ownership ties between the partners (although there are a few strategic alliances where one or more allies have minority ownership in certain of the other alliance members).

Strategic alliances arec ollaborative arrangements where two or more companies join forces to achieve mutually beneficial strategic outcomes. The competitive attraction of alliances is in allowing companies to bundle resources and competencies that are more valuable in a joint effort than when kept separate.

The most common reasons why companies enter into strategic alliances are to expedite the development of promising new technologies or products, to overcome deficits in their own technical and manufacturing expertise, to bring together the personnel and expertise needed to create desirable new skill sets and capabilities, to improve supply chain efficiency, to gain economies of scale in production and/or marketing, and to acquire or improve market access through joint marketing agreements.[1] In many instances, the resources, capabilities, skills, and knowledge bases of partner firms are more valuable when bundled in a joint effort than when kept separate.

Companies in many different industries all across the world have made strategic alliances a core part of their overall strategy; U.S. companies alone announced nearly 68,000 alliances from 1996 through 2003.[2] Genentech, a leader in biotechnology and human genetics, has formed R&D alliances with over 30 companies to boost its prospects for developing new cures for various diseases and ailments. United Airlines, American Airlines, Continental, Delta, and Northwest created an alliance to form Orbitz, an Internet travel site that enabled them to compete head-to-head against Expedia and Travelocity and, further, to give them more economical access to travelers and vacationers shopping online for airfares, rental cars, lodging, cruises, and vacation packages. Johnson & Johnson and Merck entered into an alliance to market Pepcid AC; Merck developed the stomach distress remedy and Johnson & Johnson functioned as marketer—the alliance made Pepcid the best-selling heartburn and acid indigestion remedy sold in the United States.

Failed Strategic Alliances and Cooperative Partnerships

Most alliances with an objective of technology sharing or providing market access turn out to be temporary, fulfilling their purpose after a few years because the benefits of mutual learning have occurred. Although long-term alliances sometimes prove mutually beneficial, most partners don't hesitate to terminate the alliance and go it alone when the payoffs run out. Alliances are more likely to be long-lasting when (1) they involve collaboration with suppliers or distribution allies, or (2) both parties conclude that continued collaboration is in their mutual interest, perhaps because new opportunities for learning are emerging.

A surprising number of alliances never live up to expectations. In 2007, a *Harvard Business Review* article reported that even though the number of strategic alliances increases by about 25 percent annually, about 60 percent to 70 percent of alliances continue to fail each year.[3] The high "divorce rate" among strategic allies has several causes, the most common of which are:[4]

[1] Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), p. 66. For a discussion of how to realize the advantages of strategic partnerships, see Nancy J. Kaplan and Jonathan Hurd, "Realizing the Promise of Partnerships," *Journal of Business Strategy* 23, no. 3 (May–June 2002), pp. 38–42; Salvatore Parise and Lisa Sasson, "Leveraging Knowledge Management across Strategic Alliances," *Ivey Business Journal* 66, no. 4 (March–April 2002), pp. 41–47; and David Ernst and James Bamford, "Your Alliances Are Too Stable," *Harvard Business Review* 83, no. 6 (June 2005) pp. 133–141.

[2] Jeffrey H. Dyer, Prashant Kale, and Harbir Singh, "When to Ally and When to Acquire," *Harvard Business Review* 82, no. 7/8 (July–August 2004), p. 109.

[3] Jonathan Hughes and Jeff Weiss, "Simple Rules for Making Alliances Work," *Harvard Business Review* 85, no. 11 (November 2007), pp. 122–131.

[4] Yves L. Doz and Gary Hamel, *Alliance Advantage; The Art of Creating Value through Partnering* (Boston: Harvard Business School Press, 1998), pp. 16–18.

- Diverging objectives and priorities.
- An inability to work well together.
- Changing conditions that make the purpose of the alliance obsolete.
- The emergence of more attractive technological paths.
- Marketplace rivalry between one or more allies.

Experience indicates that *alliances stand a reasonable chance of helping a company reduce competitive disadvantage but very rarely have they proved a strategic option for gaining a durable competitive edge over rivals.*

The Strategic Dangers of Relying on Alliances for Essential Resources and Capabilities

The Achilles' heel of alliances and cooperative strategies is becoming dependent on other companies for *essential* expertise and capabilities. To be a market leader (and perhaps even a serious market contender), a company must ultimately develop its own resources and capabilities in areas where internal strategic control is pivotal to protecting its competitiveness and building competitive advantage. Moreover, some alliances hold only limited potential because the partner guards its most valuable skills and expertise; in such instances, acquiring or merging with a company possessing the desired know-how and resources is a better solution.

Mergera nd Acquisition Strategies

Mergers and acquisitions are especially suited for situations in which strategic alliances or partnerships do not go far enough in providing a company with access to needed resources and capabilities.[5] Ownership ties are more permanent than partnership ties, allowing the operations of the merger/acquisition participants to be tightly integrated and creating more in-house control and autonomy. A *merger* is the combining of two or more companies into a single entity, with the newly created company often taking on a new name. An *acquisition* is a combination in which one company, the acquirer, purchases and absorbs the operations of another, the acquired. The difference between a merger and an acquisition relates more to the details of ownership, management control, and financial arrangements than to strategy and competitive advantage. The resources and competitive capabilities of the newly created enterprise end up much the same whether the combination is the result of acquisition or merger.

Combining the operations of two companies, via merger or acquisition, is an attractive strategic option for achieving operating economies, strengthening the resulting company's competencies and competitiveness, and opening up avenues of new market opportunity.

Merger and acquisition strategies typically set sights on achieving any of fiveo bjectives:[6]

[5] For an excellent discussion of the pros and cons of alliances versus acquisitions, see Jeffrey H. Dyer, Preshant Kale, and Harbir Singh, "When to Ally and When to Acquire," *Harvard Business Review* 82, no. 4 (July–August, 2004), pp. 109–115.

[6] For an excellent review of the strategic objectives of various types of mergers and acquisitions and the managerial challenges that different kinds of mergers and acquisition present, see Joseph L. Bower, "Not All M&As Are Alike—and That Matters," *Harvard Business Review* 79, no. 3 (March 2001), pp. 93–101.

1. *To create a more cost-efficient operation out of the combined companies*—When a company acquires another company in the same industry, there's usually enough overlap in operations that certain inefficient plants can be closed or distribution and sales activities can be partly combined and downsized. The combined companies may also be able to reduce supply chain costs because of buying in greater volume from common suppliers. Likewise, it is usually feasible to squeeze out cost savings in administrative activities, again by combining and downsizing such activities as finance and accounting, information technology, human resources, and so on.
2. *To expand a company's geographic coverage*—One of the best and quickest ways to expand a company's geographic coverage is to acquire rivals with operations in the desired locations. Food products companies like Nestlé, Kraft, Unilever, and Procter & Gamble have made acquisitions an integral part of their strategies to expand internationally.
3. *To extend the company's business into new product categories*—Many times a company has gaps in its product line that need to be filled. Acquisition can be a quicker and more potent way to broaden a company's product line than going through the exercise of introducing a company's own new product to fill the gap. PepsiCo's Frito-Lay division acquired Flat Earth, a maker of fruit and vegetable crisps, to broaden its lineup of snacks that appeal to heath-conscious consumers. Coca-Cola added to its lineup of healthy beverages with the $4.1 billion acquisition of Glacéau in 2007. Glacéau VitaminWater was the leading enhanced water brand in the UnitedS tates.
4. *To gain quick access to new technologies or other resources and competitive capabilities*—Making acquisitions to bolster a company's technological know-how or to expand its skills and capabilities allows a company to bypass a time-consuming and perhaps expensive *internal effort* to build desirable new resource strengths. From 2000 through April 2009, Cisco Systems purchased 85 companies to give it more technological reach and product breadth, thereby enhancing its standing as the world's biggest provider of hardware, software, and services for building and operating Internetn etworks.
5. *To lead the convergence of industries whose boundaries are being blurred by changing technologies and new market opportunities*—Such acquisitions are the result of a company's management betting that two or more distinct industries are converging into one and deciding to establish a strong position in the consolidating markets by bringing together the resources and products of several different companies. Microsoft has made a series of acquisitions that have enabled it to launch Microsoft TV Internet Protocol Television (IPTV). Microsoft TV allows broadband users to use their home computers or Xbox 360 game consoles to watch live programming, video on demand, view pictures, and listen to music.

Concepts & Connections 6.1 describes how Clear Channel Communications has used acquisitions to build a leading global position in outdoor advertising and radio broadcasting.

Concepts & Connections 6.1

CLEAR CHANNEL COMMUNICATIONS—USING MERGERS AND ACQUISITIONS TO BECOME A GLOBAL MARKET LEADER

In 2009, Clear Channel Communications was among the worldwide leaders in radio broadcasting and outdoor advertising. Clear Channel owned and operated more than 1,000 radio stations in the United States and about 900,000 outdoor advertising displays across the world. The company, which was founded in 1972 by Lowry Mays and Billy Joe McCombs, got its start by acquiring an unprofitable country-music radio station in San Antonio, Texas. Over the next 10 years, Mays learned the radio business and slowly bought other radio stations in a variety of states.

When the Federal Communications Commission loosened the rules regarding the ability of one company to own both radio and TV stations in the late 1980s, Clear Channel broadened its strategy and began acquiring small, struggling TV stations. By 1998, Clear Channel had used acquisitions to build a leading position in radio and television stations. Domestically, it owned, programmed, or sold airtime for 69 AM radio stations, 135 FM stations, and 18 TV stations in 48 local markets in 24 states.

In 1997, Clear Channel used acquisitions to establish a major position in outdoor advertising. Its first acquisition was Phoenix-based Eller Media Company, an outdoor advertising company with over 100,000 billboard facings. This was quickly followed by additional acquisitions of outdoor advertising companies, the most important of which were ABC Outdoor in Milwaukee, Wisconsin; Paxton Communications (with operations in Tampa and Orlando, Florida); Universal Outdoor; and the More Group, with outdoor operations and 90,000 displays in 24 countries.

Then in October 1999, Clear Channel made a major move by acquiring AM-FM, Inc., and changed its name to Clear Channel Communications; the AM-FM acquisition gave Clear Channel operations in 32 countries, including 830 radio stations, 19 TV stations, and more than 425,000 outdoor displays. In 2000 Clear Channel broadened its media strategy by acquiring SFX Entertainment, one of the world's largest promoters, producers, and presenters of live entertainment events.

In 2006, Clear Channel management recognized that the company's outdoor advertising and radio businesses were by far the company's most profitable businesses and began a search for buyers of its lesser performing businesses. The company spun off of its live entertainment business in 2006 and divested its 56 television stations in 2008. In 2009, Clear Channel operated 1,166 radio stations and owned and operated more than 230,000 billboards in the United States and 670,000 outdoor displays in 36 other countries.

Sources: www.clearchannel.com, accessed May 2008; and *BusinessWeek*, October 19, 1999, p. 56.

Why Mergers and Acquisitions Sometimes Fail to Produce Anticipated Results

All too frequently, mergers and acquisitions do not produce the hoped-for outcomes.[7] Cost savings may prove smaller than expected. Gains in competitive capabilities may take substantially longer to realize, or worse, may never materialize at all. Efforts to mesh the corporate cultures can stall out due to formidable resistance from organization members. Managers and employees at the acquired company may argue forcefully for continuing to do certain things the way they were done prior to the acquisition. And key employees at the acquired company can quickly become disenchanted and leave.

[7] For a more expansive discussion, see Dyer, Kale, and Singh, "When to Ally and When to Acquire," pp. 109–110.

A number of previously applauded mergers/acquisitions have yet to live up to expectations—prominent examples include the merger of Sprint and Nextel and FedEx's acquisition of Kinkos. The merger of Daimler Benz (Mercedes) and Chrysler was a failure, as was Ford's $2.5 billion acquisition of Jaguar and its $2.5 billion acquisition of Land Rover (both were sold to India's Tata Motors in 2008 for $2.3 billion). eBay's $2.6 billion acquisition of Skype (an Internet phone service company) in 2005 proved to be a failure as well—eBay wrote off $900 million of its Skype investment in 2007 and announced it would sell Skype in 2010.

Vertical Integration: Operating across More Industry Value Chain Segments

Vertical integration extends a firm's competitive and operating scope within the same industry. It involves expanding the firm's range of value chain activities backward into sources of supply and/or forward toward end users. Thus, if a manufacturer invests in facilities to produce certain component parts that it formerly purchased from outside suppliers or if it opens its own chain of retail stores to market its products to consumers, it remains in essentially the same industry as before. The only change is that it has operations in two stages of the industry value chain. For example, paint manufacturer Sherwin-Williams remains in the paint business even though it has integrated forward into retailing by operating more than 3,300 retail stores that market its paint products directly to consumers.

A **vertical integration** strategy has appeal *only* if it significantly strengthens a firm's competitive position and/or boosts its profitability.

Vertical integration strategies can aim at *full integration* (participating in all stages of the industry value chain) or *partial integration* (building positions in selected stages of the industry's total value chain). A firm can pursue vertical integration by starting its own operations in other stages in the industry's activity chain or by acquiring a company already performing the activities.

The Advantages of a Vertical Integration Strategy

The two best reasons for investing company resources in vertical integration are to strengthen the firm's competitive position and/or to boost its profitability.[8] Vertical integration has no real payoff unless it produces sufficient cost savings to justify the extra investment, adds materially to a company's technological and competitive strengths, and/or helps differentiate the company's product offering.

INTEGRATING BACKWARD TO ACHIEVE GREATER COMPETITIVENESS It is harder than one might think to generate cost savings or boost profitability by integrating backward into activities such as parts and components manufacture. For backward integration to be a viable and

[8] See Kathryn R. Harrigan, "Matching Vertical Integration Strategies to Competitive Conditions," *Strategic Management Journal* 7, no. 6 (November–December 1986), pp. 535–556; for a more extensive discussion of the advantages and disadvantages of vertical integration, see John Stuckey and David White, "When and When Not to Vertically Integrate," *Sloan Management Review* (Spring 1993), pp. 71–83.

profitable strategy, a company must be able to (1) achieve the same scale economies as outside suppliers and (2) match or beat suppliers' production efficiency with no drop-off in quality. Neither outcome is easily achieved. To begin with, a company's in-house requirements are often too small to reach the optimum size for low-cost operation—for instance, if it takes a minimum production volume of 1 million units to achieve scale economies and a company's in-house requirements are just 250,000 units, then it falls way short of being able to match the costs of outside suppliers (who may readily find buyers for 1 million or more units).

But that said, there are still occasions when a company can improve its cost position and competitiveness by performing a broader range of value chain activities in-house rather than having these activities performed by outside suppliers. The best potential for being able to reduce costs via a backward integration strategy exists in situations where suppliers have very large profit margins, where the item being supplied is a major cost component, and where the requisite technological skills are easily mastered or acquired. Backward vertical integration can produce a differentiation-based competitive advantage when performing activities internally contributes to a better-quality product/service offering, improves the caliber of customer service, or in other ways enhances the performance of a final product. Other potential advantages of backward integration include sparing a company the uncertainty of being dependent on suppliers for crucial components or support services and lessening a company's vulnerability to powerful suppliers inclined to raise prices at every opportunity. Panera Bread has been quite successful with a backward vertical integration strategy that involves internally producing fresh dough that company-owned and franchised bakery-cafés use in making baguettes, pastries, bagels and other types of bread—the company earns substantial profits from producing both these items internally rather than having these supplied by outsiders. Furthermore, Panera Bread's vertical integration strategy made good competitive sense because it not only has helped lower store operating costs, but also has ensured consistent product quality in the company's 1,185 locations in the United States.

INTEGRATING FORWARD TO ENHANCE COMPETITIVENESS

Vertical integration into forward stages of the industry value chain allows manufacturers to gain better access to end users, improve market visibility, and include the end user's purchasing experience as a differentiating feature. In many industries, independent sales agents, wholesalers, and retailers handle competing brands of the same product and have no allegiance to any one company's brand—they tend to push whatever offers the biggest profits. An independent insurance agency, for example, represents a number of different insurance companies and tries to find the best match between a customer's insurance requirements and the policies of alternative insurance companies. Under this arrangement, it is possible an agent will develop a preference for one company's policies or underwriting practices and neglect other represented insurance companies. An insurance company may conclude, therefore, that it is better off integrating forward and setting up its own local sales offices. The insurance company also has the ability to make consumers' interactions with local agents and office personnel a differentiating feature. Likewise, apparel manufacturers as varied as Ralph Lauren and Nike have integrated forward into retailing by operating full-price stores, factory outlet stores, and Internet retailing Web sites.

FORWARD VERTICAL INTEGRATION AND INTERNET RETAILING

Bypassing regular wholesale/retail channels in favor of direct sales and Internet retailing can have appeal if it lowers distribution costs, produces a relative cost advantage over certain rivals, offers higher margins, or results in lower selling prices to end users. In addition, sellers are compelled to include the Internet as a retail channel when a sufficiently large number of buyers in an industry prefer to make purchases online. However, a company that is vigorously pursuing online sales to consumers at the same time that it is also heavily promoting sales to consumers through its network of wholesalers and retailers *is competing directly against its distribution allies.* Such actions constitute *channel conflict* and create a tricky route to negotiate. A company that is actively trying to grow online sales to consumers is signaling *a weak strategic commitment to its dealers* and *a willingness to cannibalize dealers' sales and growth potential.* The likely result is angry dealers and loss of dealer goodwill. Quite possibly, a company may stand to lose more sales by offending its dealers than it gains from its own online sales effort. Consequently, in industries where the strong support and goodwill of dealer networks is essential, companies may conclude that it is important to avoid channel conflict and that *their Web site should be designed to partner with dealers rather than compete with them.*

The Disadvantages of a Vertical Integration Strategy

Vertical integration has some substantial drawbacks beyond the potential for channelc onflict.[9] The most serious drawbacks to vertical integration include:

- Vertical integration *boosts a firm's capital investment* in the industry.
- Integrating into more industry value chain segments *increases business risk* if industry growth and profitability sour.
- Vertically integrated companies are often *slow to embrace technological advances* or more efficient production methods when they are saddled with older technology or facilities.
- Integrating backward potentially results in less flexibility in accommodating shifting buyer preferences when a new product design doesn't include parts and components that the company makes in-house.
- Vertical integration poses all kinds of *capacity matching problems.* In motor vehicle manufacturing, for example, the most efficient scale of operation for making axles is different from the most economic volume for radiators, and different yet again for both engines and transmissions. Consequently, integrating across several production stages in ways that achieve the lowest feasible costs can be a monumental challenge.

[9] The resilience of vertical integration strategies despite the disadvantages is discussed in Thomas Osegowitsch and Anoop Madhok, "Vertical Integration Is Dead, or Is It?" *Business Horizons* 46, no. 2 (March–April 2003), pp. 25–35.

- Integration forward or backward often requires the *development of new skills and business capabilities.* Parts and components manufacturing, assembly operations, wholesale distribution and retailing, and direct sales via the Internet are different businesses with different key success factors.

In today's world of close relationships with suppliers and efficient supply chain management, very few businesses can make a case for integrating backward into the business of suppliers.

OutsourcingS trategies: Narrowing the Boundaries of the Business

Absent the ability to strengthen the firm's competitive position or boost its profitability, integrating forward or backward into additional industry value chain stages is not likely to be an attractive strategy option. Outsourcing forgoes attempts to perform certain value chain activities internally and instead farms them out to outside specialists and strategic allies. Outsourcing makes strategic sense whenever:

- *An activity can be performed better or more cheaply by outside specialists.* Nikon—by outsourcing the distribution of digital cameras to UPS—gained the capability to deliver its cameras to retailers in the United States, Latin America, and the Caribbean in as little as two days after an order was placed even though its manufacturing facilities were located in Japan, Korea, and Indonesia.
- *The activity is not crucial to the firm's ability to achieve sustainable competitive advantage and won't hollow out its capabilities, core competencies, or technical know-how.* Outsourcing of support activities such as maintenance services, data processing and data storage, fringe benefit management, and Web site operations has become commonplace. Colgate-Palmolive, for instance, has been able to reduce its information technology operational costs by more than 10 percent per year through an outsourcing agreement with IBM.
- *It improves a company's ability to innovate.* Collaborative partnerships with worldclass suppliers who have cutting-edge intellectual capital and are early adopters of the latest technology give a company access to ever better parts and components.
- *It allows a company to concentrate on its core business, leverage its key resources and core competencies, and do even better what it already does best.* A company is better able to build and develop its own competitively valuable competencies and capabilities when it concentrates its full resources and energies on performing those activities. Coach, for example, devotes its energy to designing new styles of ladies' handbags and leather accessories, opting to outsource handbag production to 40 contract manufacturers in 15 countries.

A company should generally *not* perform any value chain activity internally that can be performed more efficiently or effectively by outsiders; the chief exception is when a particular activity is strategically crucial.

THE BIG RISK OF AN OUTSOURCING STRATEGY The biggest danger of outsourcing is that a company will farm out the wrong types of activities and thereby hollow out its own capabilities.[10] In such cases, a company loses touch with the very activities and expertise that over the long run determine its success. But most companies are alert to this danger and take actions to protect against being held hostage by outside suppliers. Cisco Systems guards against loss of control and protects its manufacturing expertise by designing the production methods that its contract manufacturers must use. Cisco keeps the source code for its designs proprietary, thereby controlling the initiation of all improvements and safeguarding its innovations from imitation. Further, Cisco uses the Internet to monitor the factory operations of contract manufacturers around the clock, and can therefore know immediately when problems arise and decide whether to get involved.

Strategic Options to Improve a Company's Market Position—The Use of Strategic Offensives

Beyond strategic options for expanding a company's business scope, enhancing its collection of resources and capabilities, improving efficiency, gaining economies of scale, and accessing new markets, managers must consider strategic options for improving a company's market position. There are times when a company *should be aggressive and go on the offensive.* Strategic offensives are called for when a company spots opportunities to gain profitable market share at the expense of rivals or when a company has no choice but to try to whittle away at a strong rival's competitive advantage. Companies like Walmart, Toyota, Microsoft, and Google play hardball, aggressively pursuing competitive advantage and trying to reap the benefits a competitive edge offers—a leading market share, excellent profit margins, and rapid growth.[11]

Choosing the Basis for Competitive Attack

As a general rule, strategic offensives should be grounded in a company's competitive assets and strong points and exploit competitor weaknesses.[12] Ignoring the need to tie a strategic offensive to a company's competitive strengths and what it does best is like going to war with a popgun—the prospects for success are dim. For instance, it is foolish for a company with relatively high costs to employ a price-cutting offensive.

The best offensives use a company's resource strengths to attack rivals in those competitive areas where they are weak.

[10] For a good discussion of the problems that can arise from outsourcing, see Jérôme Barthélemy, "The Seven Deadly Sins of Outsourcing," *Academy of Management Executive* 17, no. 2 (May 2003), pp. 87–100.

[11] For an excellent discussion of aggressive offensive strategies, see George Stalk, Jr., and Rob Lachenauer, "Hardball: Five Killer Strategies for Trouncing the Competition," *Harvard Business Review* 82, no. 4 (April 2004), pp. 62–71. A discussion of offensive strategies particularly suitable for industry leaders is presented in Richard D'Aveni, "The Empire Strikes Back: Counterrevolutionary Strategies for Industry Leaders," *Harvard Business* Review 80, no. 11 (November 2002), pp. 66–74.

[12] For an excellent discussion of how to wage offensives against strong rivals, see David B. Yoffie and Mary Kwak, "Mastering Balance: How to Meet and Beat a Stronger Opponent," *California Management Review* 44, no. 2 (Winter 2002), pp. 8–24.

Likewise, it is ill-advised to pursue a product innovation offensive without having proven expertise in R&D, new product development, and speeding new or improved products to market.

The principal offensive strategy options include the following:

1. *Attacking the competitive weaknesses of rivals.* For example, a company with especially good customer service capabilities can make special sales pitches to the customers of those rivals who provide subpar customer service. Aggressors with a recognized brand name and strong marketing skills can launch efforts to win customers away from rivals with weak brandr ecognition.
2. *Offering an equally good or better product at a lower price.* Lower prices can produce market share gains if competitors offering similarly performing products don't respond with price cuts of their own. Price-cutting offensives are best initiated by companies that have *first achieved a cost advantage.*[13]
3. *Pursuing continuous product innovation to draw sales and market share away from less innovative rivals.* Ongoing introductions of new/improved products can put rivals under tremendous competitive pressure, especially when rivals' new product development capabilities are weak.
4. *Leapfrogging competitors by being the first to market with next generation technology or products.* Microsoft got its next-generation Xbox 360 to market a full 12 months ahead of Sony's PlayStation 3 and Nintendo's Wii, helping it convince video gamers to buy an Xbox 360 rather than wait for the new PlayStation 3 and Wii to hit the market.
5. *Adopting and improving on the good ideas of other companies (rivals or otherwise).*[14] The idea of warehouse-type home improvement centers did not originate with Home Depot co-founders Arthur Blank and Bernie Marcus; they got the "big box" concept from their former employer Handy Dan Home Improvement. But they were quick to improve on Handy Dan's business model and strategy and take Home Depot to a higher plateau in terms of product line breadth and customer service.
6. *Deliberately attacking those market segments where a key rival makes big profits.*[15] Toyota has launched a hardball attack on General Motors, Ford, and Chrysler in the U.S. market for light trucks and SUVs, the very market arena where the Detroit automakers typically earn their big profits (roughly $10,000 to $15,000 per vehicle). Toyota's pick-up trucks and SUVs have weakened the Big 3 U.S. automakers by taking away sales and market share that they desperately need.
7. *Maneuvering around competitors to capture unoccupied or less contested market territory.* Examples include launching initiatives to build strong positions in geographic areas or product categories where close rivals have little or no market presence.

[13] Ian C. MacMillan, Alexander B. van Putten, and Rita Gunther McGrath, "Global Gamesmanship," *Harvard Business Review* 81, no. 5 (May 2003), pp. 66–67; also, see Askay R. Rao, Mark E. Bergen, and Scott Davis, "How to Fight a Price War," *Harvard Business Review* 78, no. 2 (March–April, 2000), pp. 107–116.

[14] Stalk and Lachenauer, "Hardball: Five Killer Strategies for Trouncing the Competition," p. 64.

[15] Ibid., p. 67.

8. *Using hit-and-run or guerrilla warfare tactics to grab sales and market share from complacent or distracted rivals.* Options for "guerrilla offensives" include occasional low-balling on price (to win a big order or steal a key account from a rival) or surprising key rivals with sporadic but intense bursts of promotional activity (offering a 20 percent discount for one week to draw customers away from rival brands).[16] Guerrilla offensives are particularly well suited to small challengers who have neither the resources nor the market visibility to mount a full-fledged attack on industry leaders.
9. *Launching a preemptive strike to capture a rare opportunity or secure an industry's limited resources.*[17] What makes a move preemptive is its one-of-a-kind nature—whoever strikes first stands to acquire competitive assets that rivals can't readily match. Examples of preemptive moves include (1) securing the best distributors in a particular geographic region or country; (2) moving to obtain the most favorable site at a new interchange or intersection, in a new shopping mall, and so on; and (3) tying up the most reliable, high-quality suppliers via exclusive partnerships, long-term contracts, or even acquisition. To be successful, a preemptive move doesn't have to totally block rivals from following or copying; it merely needs to give a firm a prime position that is not easily circumvented.

Choosing WhichRiv alst o Attack

Offensive-minded firms need to analyze which of their rivals to challenge as well as how to mount that challenge. The following are the best targets for offensiveat tacks:[18]

- *Market leaders that are vulnerable*—Offensive attacks make good sense when a company that leads in terms of size and market share is not a true leader in terms of serving the market well. Signs of leader vulnerability include unhappy buyers, an inferior product line, a weak competitive strategy with regard to low-cost leadership or differentiation, a preoccupation with diversification into other industries, and mediocre or declining profitability.
- *Runner-up firms with weaknesses in areas where the challenger is strong*—Runner-up firms are an especially attractive target when a challenger's resource strengths and competitive capabilities are well-suited to exploiting their weaknesses.
- *Struggling enterprises that are on the verge of going under*—Challenging a hard-pressed rival in ways that further sap its financial strength and competitive position can hasten its exit from the market.

[16] For an interesting study of how small firms can successfully employ guerrilla-style tactics, see Ming-Jer Chen and Donald C. Hambrick, "Speed, Stealth, and Selective Attack: How Small Firms Differ from Large Firms in Competitive Behavior," *Academy of Management Journal* 38, no. 2 (April 1995), pp. 453–482. Other discussions of guerrilla offensives can be found in Ian MacMillan, "How Business Strategists Can Use Guerrilla Warfare Tactics," *Journal of Business Strategy* 1, no. 2 (Fall 1980), pp. 63–65; William E. Rothschild, "Surprise and the Competitive Advantage," *Journal of Business Strategy* 4, no. 3 (Winter 1984), pp. 10–18; Kathryn R. Harrigan, *Strategic Flexibility* (Lexington, MA: Lexington Books, 1985), pp. 30–45; and Liam Fahey, "Guerrilla Strategy: The Hit-and-Run Attack," in *The Strategic Management Planning Reader*, ed. Liam Fahey (Englewood Cliffs, NJ: Prentice Hall, 1989), pp. 194–197.

[17] The use of preemptive strike offensives is treated comprehensively in Ian MacMillan, "Preemptive Strategies," *Journal of Business Strategy* 14, no. 2 (Fall 1983), pp. 16–26.

[18] Philip Kotler, *Marketing Management*, 5th ed. (Englewood Cliffs, NJ: Prentice Hall, 1984), p. 400.

- *Small local and regional firms with limited capabilities*—Because small firms typically have limited expertise and resources, a challenger with broader capabilities is well positioned to raid their biggest and best customers.

Blue Ocean Strategy—A Special Kind of Offensive

A **blue ocean strategy** seeks to gain a dramatic and durable competitive advantage *by abandoning efforts to beat out competitors in existing markets and, instead, inventing a new industry or distinctive market segment that renders existing competitors largely irrelevant and allows a company to create and capture altogether new demand.*[19] This strategy views the business universe as consisting of two distinct types of market space. One is where industry boundaries are defined and accepted, the competitive rules of the game are well understood by all industry members, and companies try to outperform rivals by capturing a bigger share of existing demand; in such markets, lively competition constrains a company's prospects for rapid growth and superior profitability since rivals move quickly to either imitate or counter the successes of competitors. The second type of market space is a "blue ocean" where the industry does not really exist yet, is untainted by competition, and offers wide open opportunity for profitable and rapid growth if a company can come up with a product offering and strategy that allows it to create new demand rather than fight over existing demand. A terrific example of such wide open or blue ocean market space is the online auction industry that eBay created and now dominates.

Blue ocean strategies offerg rowth in revenues and profits by discovering or inventing new industry segments that create altogether new demand.

Other examples of companies that have achieved competitive advantages by creating blue ocean market spaces include Starbucks in the coffee shop industry, Dollar General in extreme discount retailing, FedEx in overnight package delivery, and Cirque du Soleil in live entertainment. Cirque du Soleil "reinvented the circus" by creating a distinctively different market space for its performances (Las Vegas night clubs and theater-type settings) and pulling in a whole new group of customers—adults and corporate clients—who were willing to pay several times more than the price of a conventional circus ticket to have an "entertainment experience" featuring sophisticated clowns and star-quality acrobatic acts in a comfortable atmosphere. Companies that create blue ocean market spaces can usually sustain their initially won competitive advantage without encountering major competitive challenge for 10 to 15 years because of high barriers to imitation and the strong brand name awareness that a blue ocean strategy can produce.

Strategic Options to Protect a Company's Market Position and Competitive Advantage—The Use of Defensive Strategies

In a competitive market, all firms are subject to offensive challenges from rivals. The purposes of defensive strategies are to lower the risk of being attacked, weaken the impact of any attack that occurs, and influence challengers to aim

[19] W. Chan Kim and Renée Mauborgne, "Blue Ocean Strategy," *Harvard Business Review* 82, no. 10 (October 2004), pp. 76–84.

Good defensive strategies can help protect competitive advantage but rarely are the basis for creating it.

their efforts at other rivals. While defensive strategies usually don't enhance a firm's competitive advantage, they can definitely help fortify its competitive position. Defensive strategies can take either of two forms: actions to block challengers and actions signaling the likelihood of strong retaliation.

Blocking the Avenues Open to Challengers

The most frequently employed approach to defending a company's present position involves actions to restrict a competitive attack by a challenger. There are any number of obstacles that can be put in the path of would-be challengers.[20] A defender can introduce new features, add new models, or broaden its product line to close off vacant niches to opportunity-seeking challengers. It can thwart the efforts of rivals to attack with a lower price by maintaining economy-priced options of its own. It can try to discourage buyers from trying competitors' brands by making early announcements about upcoming new products or planned price changes. Finally, a defender can grant volume discounts or better financing terms to dealers and distributors to discourage them from experimenting with other suppliers.

Signaling Challengers That Retaliation Is Likely

The goal of signaling challengers that strong retaliation is likely in the event of an attack is either to dissuade challengers from attacking at all or to divert them to less threatening options. Either goal can be achieved by letting challengers know the battle will cost more than it is worth. Would-be challengers can be signaled by:[21]

- Publicly announcing management's commitment to maintain the firm's present market share.
- Publicly committing the company to a policy of matching competitors' terms or prices.
- Maintaining a war chest of cash and marketable securities.
- Making an occasional strong counter-response to the moves of weak competitors to enhance the firm's image as a tough defender.

Timing a Company's Strategic Moves

When to make a strategic move is often as crucial as *what* move to make. Timing is especially important when *first-mover advantages* or *disadvantages* exist.[22]

Because of first-mover advantages and disadvantages, competitive advantage can spring from *when* a move is made as well as from *what* move is made.

Being first to initiate a strategic move can have a high payoff when (1) pioneering helps build a firm's image and reputation with buyers; (2) early commitments to new technologies, new-style components, new or emerging distribution channels, and so on, can produce

[20] Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), pp. 489–494.
[21] Ibid., pp. 495–497. The list here is selective; Porter offers a greater number of options.
[22] Porter, *Competitive Advantage*, pp. 232–233.

an absolute cost advantage over rivals; (3) first-time customers remain strongly loyal to pioneering firms in making repeat purchases; and (4) moving first constitutes a preemptive strike, making imitation extra hard or unlikely. The bigger the first-mover advantages, the more attractive making the first move becomes.[23]

Sometimes, though, markets are slow to accept the innovative product offering of a first-mover, in which case a fast follower with substantial resources and marketing muscle can overtake a first-mover (as Fox News has done in competing against CNN to become the leading cable news network). Sometimes furious technological change or product innovation makes a first-mover vulnerable to quickly appearing next-generation technology or products—Motorola, once a market leader in mobile phones, has been victimized by the far more innovative phones offered by Apple (iPhone) and Research in Motion (Blackberry). Hence, there are no guarantees that a first-mover will win sustainable competitive advantage.[24]

To sustain any advantage that may initially accrue to a pioneer, a first-mover needs to be a fast learner and continue to move aggressively to capitalize on any initial pioneering advantage. If a first-mover's skills, know-how, and actions are easily copied or even surpassed, then followers and even late-movers can catch or overtake the first-mover in a relatively short period. What makes being a first-mover strategically important is not being the first company to do something but rather being the first competitor to put together the precise combination of features, customer value, and sound revenue/cost/profit economics that gives it an edge over rivals in the battle for market leadership.[25] If the marketplace quickly takes to a first-mover's innovative product offering, a first-mover must have large-scale production, marketing, and distribution capabilities if it is to stave off fast-followers who possess similar resources capabilities. If technology is advancing at torrid pace, a first-mover cannot hope to sustain its lead without having strong capabilities in R&D, design, and new product development, along with the financial strength to fund these activities. Concepts & Connections 6.2 describes how Amazon.com achieved a first-mover advantage in online retailing.

TheP otentialf orLa te-Mover Advantages or First-Mover Disadvantages

There are instances when there are actually *advantages* to being an adept follower rather than a first-mover. Late-mover advantages (or *first-mover disadvantages*) arise in four instances:

- When pioneering leadership is more costly than imitating followership and only negligible experience or learning-curve benefits accrue to the

[23] For research evidence on the effects of pioneering versus following, see Jeffrey G. Covin, Dennis P. Slevin, and Michael B. Heeley, "Pioneers and Followers: Competitive Tactics, Environment, and Growth," *Journal of Business Venturing* 15, no. 2 (March 1999), pp. 175–210; and Christopher A. Bartlett and Sumantra Ghoshal, "Going Global: Lessons from Late-Movers," *Harvard Business Review* 78, no.2 (March–April 2000), pp. 132–145.

[24] For a more extensive discussion of this point, see Fernando Suarez and Gianvito Lanzolla, "The Half-Truth of First-Mover Advantage," *Harvard Business Review* 83 no. 4 (April 2005), pp. 121–127.

[25] Gary Hamel, "Smart Mover, Dumb Mover," *Fortune*, September 3, 2001, p. 195.

Concepts & Connections 6.2

AMAZON.COM'S FIRST-MOVER ADVANTAGE IN ONLINE RETAILING

Amazon.com's path to world's largest online retailer began in 1994 when Jeff Bezos, a Manhattan hedge fund analyst at the time, noticed that the number of Internet users was increasing by 2,300 percent annually. Bezos saw the tremendous growth as an opportunity to sell products online that would be demanded by a large number of Internet users and could be easily shipped. Bezos launched the online bookseller, Amazon.com, in 1995. The start-up's revenues soared to $148 million in 1997, $610 million in 1998, and $1.6 billion in 1999. Bezo's business plan hatched while on a cross-country trip with his wife in 1994 made him *Time*'s Person of the Year in 1999.

Amazon.com's early entry into online retailing had delivered a first-mover advantage, but between 2000 and 2009, Bezos undertook a series of additional strategic initiatives to solidify the company's number-one ranking in the industry. Bezos undertook a massive building program in the late 1990s that added five new warehouses and fulfillment centers totaling $300 million. The additional warehouse space was added years before it was needed, but Bezos wanted to insure that, as demand continued to grow, the company could continue to offer its customers the best selection, the lowest prices, and the cheapest and most convenient delivery. The company also expanded its product line to include sporting goods, tools, toys, grocery items, electronics, and digital music downloads. Amazon.com's 2008 revenues of $19.2 billion made it the world's largest Internet retailer and Jeff Bezos' shares in Amazon.com made him the 110th wealthiest person in the world with an estimated net worth of $8.2 billion.

Not all of Bezos' efforts to maintain a first-mover advantage in online retailing were a success. Bezos commented in a 2008 *Fortune* article profiling the company, "We were investors in every bankrupt, 1999-vintage e-commerce start-up. Pets.com, living.com, kozmo.com. We invested in a lot of high-profile flameouts." He went on to specify that although the ventures were a "waste of money," they "didn't take us off our own mission." Bezos also suggested that gaining advantage as a first-mover is "taking a million tiny steps—and learning quickly from your missteps."

Sources: Mark Brohan, "The Top 500 Guide," *Internet Retailer,* June 2009, (accessed at www.internetretailer.com on June 17, 2009); Josh Quittner, "How Jeff Bezos Rules the Retail Space," *Fortune,* May 5, 2008, pp. 126–134.

leader—a condition that allows a follower to end up with lower costs than the first-mover.

- When the products of an innovator are somewhat primitive and do not live up to buyer expectations, thus allowing a clever follower to win disenchanted buyers away from the leader with better-performing products.
- When the demand side of the marketplace is skeptical about the benefits of a new technology or product being pioneered by a first-mover.
- When rapid market evolution (due to fast-paced changes in either technology or buyer needs and expectations) gives fast-followers and maybe even cautious late-movers the opening to leapfrog a first-mover's products with more attractive next version products.

Deciding Whether to Be an Early-Mover or Late-Mover

In weighing the pros and cons of being a first-mover versus a fast-follower versus a slow-mover, it matters whether the race to market leadership in a particular industry is a marathon or a sprint. In marathons, a slow-mover is not unduly penalized—first-mover advantages can be fleeting, and there's ample time for fast-followers and sometimes even late-movers to play catch-up.[26] Thus the speed at which the pioneering innovation is likely to catch on matters considerably as companies struggle with whether to pursue a particular emerging market opportunity aggressively or cautiously. For instance, it took 18 months for 10 million users to sign up for Hotmail, 5.5 years for worldwide mobile phone use to grow from 10 million to 100 million worldwide, and close to 10 years for the number of at-home broadband subscribers to grow to 100 million worldwide. The lesson here is that there is a market-penetration curve for every emerging opportunity; typically, the curve has an inflection point at which all the pieces of the business model fall into place, buyer demand explodes, and the market takes off. The inflection point can come early on a fast-rising curve (like use of e-mail) or farther on up a slow-rising curve (like use of broadband). Any company that seeks competitive advantage by being a first-mover thus needs to ask some hard questions:

- Does market take-off depend on the development of complementary products or services that currently are not available?
- Is new infrastructure required before buyer demand can surge?
- Will buyers need to learn new skills or adopt new behaviors? Will buyers encounter high switching costs?
- Are there influential competitors in a position to delay or derail the efforts of a first-mover?

When the answers to any of these questions are yes, then a company must be careful not to pour too many resources into getting ahead of the market opportunity—the race is likely going to be more of a 10-year marathon than a two-year sprint.

[26] Ibid., p. 192; and Costas Markides and Paul A. Geroski, "Racing to be 2nd: Conquering the Industries of the Future," *Business Strategy Review* 15, no. 4 (Winter 2004), pp. 25–31.

KeyP oints

Once a company has selected which of the five basic competitive strategies to employ in its quest for competitive advantage, then it must decide whether and how to supplement its choice of a basic competitive strategy approach.

1. Many companies are using strategic alliances and collaborative partnerships to help them in the race to build a global market presence or be a leader in the industries of the future. Strategic alliances are an attractive, flexible, and often cost-effective means by which companies can gain access to missing technology, expertise, and business capabilities.
2. Mergers and acquisitions are another attractive strategic option for strengthening a firm's competitiveness. When the operations of two companies are combined via merger or acquisition, the new company's competitiveness can be enhanced in any of several ways—lower costs; stronger technological skills; more or better

competitive capabilities; a more attractive lineup of products and services; wider geographic coverage; and/or greater financial resources with which to invest in R&D, add capacity, or expand into new areas.

3. Vertically integrating forward or backward makes strategic sense only if it strengthens a company's position via either cost reduction or creation of a differentiation-based advantage. Otherwise, the drawbacks of vertical integration (increased investment, greater business risk, increased vulnerability to technological changes, and less flexibility in making product changes) are likely to outweigh any advantages.
4. Outsourcing pieces of the value chain formerly performed in-house can enhance a company's competitiveness whenever (1) an activity can be performed better or more cheaply by outside specialists; (2) the activity is not crucial to the firm's ability to achieve sustainable competitive advantage and won't hollow out its core competencies, capabilities, or technical know-how; (3) it improves a company's ability to innovate; and/or (4) it allows a company to concentrate on its core business and do what it does best.
5. Companies have a number of offensive strategy options for improving their market positions and trying to secure a competitive advantage: (1) attacking competitors weaknesses, (2) offering an equal or better product at a lower price, (3) pursuing sustained product innovation, (4) leapfrogging competitors by being first to adopt next-generation technologies or the first to introduce next-generation products, (5) adopting and improving on the good ideas of other companies, (6) deliberately attacking those market segments where key rivals make big profits, (7) going after less contested or unoccupied market territory, (8) using hit-and-run tactics to steal sales away from unsuspecting rivals, and (9) launching preemptive strikes. A blue ocean offensive strategy seeks to gain a dramatic and durable competitive advantage by abandoning efforts to beat out competitors in existing markets and, instead, inventing a new industry or distinctive market segment that renders existing competitors largely irrelevant and allows a company to create and capture altogether new demand.
6. Defensive strategies to protect a company's position usually take the form of making moves that put obstacles in the path of would-be challengers and fortify the company's present position while undertaking actions to dissuade rivals from even trying to attack (by signaling that the resulting battle will be more costly to the challenger than it is worth).
7. The timing of strategic moves also has relevance in the quest for competitive advantage. Company managers are obligated to carefully consider the advantages or disadvantages that attach to being a first-mover versus a fast-follower versusaw ait-and-seel ate-mover.

Assurance of Learning Exercises

1. Using your university library's subscription to Lexis-Nexis, EBSCO, or a similar database, perform a search on "acquisition strategy." Identify at least two companies in different industries that are using acquisitions to strengthen their market positions. How have these acquisitions enhanced the acquiring companies' resource strengths and competitive capabilities? **LO2**
2. Go to www.bridgestone.co.jp/english/info and review information about Bridgestone Corporation's Tire and Raw Materials operations under the Corporate Information and Data Library links. To what extent is the company vertically **LO3**

integrated? What segments of the industry value chain has the company chosen to perform? What are the benefits and liabilities of Bridgestone's vertical integration strategy?

LO4 3. Go to www.google.com and do a search on "outsourcing." Identify at least two companies in different industries that have entered into outsourcing agreements with firms with specialized services. In addition, describe what value chain activities the companies have chosen to outsource. Do any of these outsourcing agreements seem likely to threaten any of the companies' competitive capabilities?

Exercises for Simulation Participants

LO2 1. Does your company have the option to merge with or acquire other companies? If so, which rival companies would you like to acquire or merge with?

LO3

LO4 2. Isyo urc ompanyv erticallyi ntegrated?E xplain.

LO7 3. Is your company able to engage in outsourcing? If so, what do you see as the pros and cons of outsourcing?

4. What options for being a first-mover does your company have? Do any of these first-mover options hold competitive advantage potential?

Chapter 7

Strategies for Competing in International Markets

Chapter Learning Objectives

LO1. Develop an understanding of the primary reasons companies choose to compete in international markets.

LO2. Learn how and why differing market conditions across countries influence a company's strategy choices in international markets.

LO3. Gain familiarity with the strategic options for entering and competing in foreign markets.

LO4. Understand how multinational companies go about building competitive advantage in foreign markets.

LO5. Gain an understanding of the unique characteristics of competing in emerging markets.

Any company that aspires to industry leadership in the 21st century must think in terms of global, not domestic, market leadership. The world economy is globalizing at an accelerating pace as countries previously closed to foreign companies open up their markets, as countries with previously planned economies embrace market or mixed economies, as information technology shrinks the importance of geographic distance, and as ambitious, growth-minded companies race to build stronger competitive positions in the markets of more and more countries.

This chapter focuses on strategy options for expanding beyond domestic boundaries and competing in the markets of either a few or a great many countries. In the process of exploring options for competing internationally, we will introduce such concepts as multicountry competition, global competition, profit sanctuaries, and cross-country differences in cultural, demographic, and market conditions. The chapter also includes sections on strategy options for entering and competing in foreign markets; the importance of locating operations in the most advantageous countries; and the special circumstances of competing in such emerging markets as China, India, Brazil, Russia, and Eastern Europe.

WhyC ompaniesE xpand into International Markets

A company may opt to expand outside its domestic market for any of four major reasons:

1. *To gain access to new customers*—Expanding into foreign markets offers potential for increased revenues, profits, and long-term growth and becomes an especially attractive option when a company's home markets aremat ure.
2. *To achieve lower costs and enhance the firm's competitiveness*—Many companies are driven to sell in more than one country because domestic sales volume alone is not large enough to fully capture manufacturing economies of scale or learning-curve effects. The relatively small size of country markets in Europe explains why companies like Michelin, BMW, and Nestlé long ago began selling their products all across Europe and then moved into markets in North America and Latin America.
3. *To capitalize on its core competencies*—A company may be able to leverage its competencies and capabilities into a position of competitive advantage in foreign markets as well as domestic markets. Walmart is capitalizing on its considerable expertise in discount retailing to expand into the United Kingdom, Japan, China, and Latin America. Walmart executives are particularly excited about the company's growth opportunities in China.
4. *To spread its business risk across a wider market base*—A company spreads business risk by operating in a number of different foreign countries rather than depending entirely on operations in its domestic market. Thus, if the economies of North American countries turn down for a period of time, a company with operations across much of the world may be sustained by buoyant sales in Latin America, Asia, or Europe.

In a few cases, companies in industries based on natural resources (e.g., oil and gas, minerals, rubber, and lumber) often find it necessary to operate in the international arena because attractive raw material supplies are located in foreignc ountries.

Factors That Shape Strategy Choices in International Markets

There are four important factors that shape a company's strategic approach to competing in foreign markets: (1) the degree to which there are important cross-country differences in cultural, demographic, and market conditions, (2) whether opportunities exist to gain a location-based competitive advantage, (3) the risks of adverse shifts in currency exchange rates, and (4) the extent to which governmental policies affect the business environment.

Cross-CountryD ifferencesin C ultural, Demographic, and Market Conditions

Regardless of a company's motivation for expanding outside its domestic markets, the strategies it uses to compete in foreign markets must be situation-driven. Cultural, demographic, and market conditions vary significantly among the countries of the world.[1] *Cultures and lifestyles* are the most obvious areas in which countries differ; *market demographics* and *income levels* are close behind. For many product categories, consumers in Spain do not have the same tastes, preferences, and buying habits as consumers in Norway; buyers differ yet again in Greece, Chile, New Zealand, and Taiwan. Less than 20 percent of the populations of Brazil, India, and China have annual purchasing power equivalent to $25,000. Middle-class consumers represent a much smaller portion of the population in these and other emerging countries than in North America, Japan, and much of Western Europe—China's middle class numbers about 125 million out of a population of 1.3 billion.[2] Sometimes, product designs suitable in one country are inappropriate in another—for example, in the United States electrical devices run on 110-volt electrical systems, but in some European countries the standard is a 220–240 volt electric system, necessitating the use of different electrical designs and components. In parts of Asia refrigerators are a status symbol and may be placed in the living room, leading to preferences for stylish designs and colors—in India bright blue and red are popular colors. In other Asian countries household space is constrained and many refrigerators are only four feet high so that the top can be used for storage.

Similarly, *market growth* varies from country to country. In emerging markets like India, China, Brazil, and Malaysia, market growth potential is

[1] For an insightful discussion of how much significance these kinds of demographic and market differences have, see C. K. Prahalad and Kenneth Lieberthal, "The End of Corporate Imperialism," *Harvard Business Review* 76, no. 4 (July–August 1998), pp. 68–79; and Marcus Alexander and Harry Korine, "When You Shouldn't Go Global," *Harvard Business Review* 86, no. 12 (December 2008), pp. 70–77.

[2] Joseph Caron, "The Business of Doing Business with China: An Ambassador Reflects," *Ivey Business Journal* 69, no. 5 (May–June 2005), p. 2.

far higher than in the more mature economies of Britain, Denmark, Canada, and Japan. In automobiles, for example, the potential for market growth is explosive in China, where 2008 sales of new vehicles amounted to just over 9.3 million in a country with 1.3 billion people. Market growth can be limited by the lack of infrastructure or established distribution and retail networks in emerging markets. In India, there are well-developed national channels for distribution of goods to the nation's 3 million retailers, whereas in China distribution is primarily local. Also, the competitive rivalry in some country marketplaces is only moderate, while others are characterized by strong or fierce competition.

One of the biggest concerns of companies competing in foreign markets is whether to customize their offerings in each different country market to match the tastes and preferences of local buyers or whether to offer a mostly standardized product worldwide. While making products closely matched to local tastes makes them more appealing to local buyers, customizing a company's products country by country may have the effect of raising production and distribution costs due to the greater variety of designs and components, shorter production runs, and the complications of added inventory handling and distribution logistics. *The tension between the market pressures to localize a company's product offerings country-by-country and the competitive pressures to lower costs is one of the big strategic issues that participants in foreign markets have to resolve.*

Aside from the basic cultural and market differences among countries, a company also has to pay special attention to location advantages that stem from country-to-country variations in manufacturing and distribution costs, the risks of adverse shifts in exchange rates, and the economic and political demands of host governments.

Gaining a Location-Based Competitive Advantage

Differences in wage rates, worker productivity, inflation rates, energy costs, tax rates, government regulations, and the like create sizable country-to-country variations in manufacturing costs. Plants in some countries have major manufacturing cost advantages because of lower input costs (especially labor), relaxed government regulations, the proximity of suppliers, or unique natural resources. In such cases, the low-cost countries become principal production sites, with most of the output exported to markets in other parts of the world. Companies that build production facilities in low-cost countries (or that source their products from contract manufacturers in these countries) have a competitive advantage over rivals with plants in countries where costs are higher. The competitive role of low manufacturing costs is most evident in low-wage countries like China, India, Pakistan, Mexico, Brazil, and several countries in Africa that have become production havens for manufactured goods with high labor content (especially textiles and apparel). Hourly compensation costs for production workers in China averaged about \$0.80 an hour in 2007 versus about \$3.00 in Mexico, \$6.00 in Brazil, \$8.00 in Hungary, \$19.00 in New Zealand, \$24.50 in the U.S., \$29.00 in Canada, \$38.00 in Germany, and \$48.50 in Norway.[3] China is fast becoming

[3] "International Comparisons of Hourly Compensation Costs for in Manufacturing, 2007," *U.S. Department of Labor Bureau of Labor Statistics Newsletter*, March 26, 2009.

the manufacturing capital of the world—virtually all of the world's major manufacturing companies now have facilities in China. Likewise, concerns about short delivery times and low shipping costs make some countries better locations than others for establishing distribution centers.

The quality of a country's business environment also offers locational advantages—the governments of some countries are anxious to attract foreign investments and go all-out to create a business climate that outsiders will view as favorable. A good example is Ireland, which has one of the world's most pro-business environments. Ireland offers companies very low corporate tax rates, has a government that is responsive to the needs of industry, and aggressively recruits high-tech manufacturing facilities and multinational companies. Ireland's policies were a major factor in Boston Scientific's decision to locate three medical device research and production facilities in Ireland that employ over 4,000 people. Another locational advantage is the clustering of suppliers of components and capital equipment, infrastructure suppliers (universities, vocational training providers, research enterprises), and makers of complementary products in close proximity to a company's major operations—such geographic clustering not only facilitates close collaboration but in many cases also produces significant cost savings.

The Risks of Adverse Exchange Rate Shifts

The volatility of exchange rates greatly complicates the issue of geographic cost advantages. Currency exchange rates often move up or down 20 to 40 percent annually. Changes of this magnitude can either totally wipe out a country's low-cost advantage or transform a former high-cost location into a competitive-cost location. The growing strength of the euro relative to the U.S. dollar has encouraged a number of European manufacturers such as Volkswagen, Fiat, and Airbus to shift production from European factories to new facilities in the United States. Also, the weakening dollar caused Chrysler to discontinue its contract manufacturing agreement with an Austrian firm for assembly of minivans and Jeeps sold in Europe. Beginning in 2008, Chrysler's vehicles sold in Europe were exported from its factories in Illinois and Missouri. The weak dollar was also a factor in Ford's and GM's recent decisions to begin exporting U.S.-made vehicles to China and Latin America. *The lesson of fluctuating exchange rates is that companies that export goods to foreign countries always gain in competitiveness when the currency of the country in which the goods are manufactured is weak. Exporters are disadvantaged when the currency of the country where goods are being manufactured grows stronger.*

The Impact of Host Government Policies on the Local Business Climate

National governments enact all kinds of measures affecting business conditions and the operations of foreign companies in their markets. Examples of host government policies affecting foreign-based companies include:

- Local content requirements on goods made inside their borders by foreign-basedc ompanies.
- Policies that protect local companies from foreign competition.

- Restrictions on exports because of national security concerns.
- Price regulation of imported and locally produced goods.
- Deliberately burdensome procedures and requirements for imported goods to pass customs inspection.
- Tariffs or quotas on the import of certain goods.
- Subsidies and low-interest loans for domestic companies competing against foreignr ivals.

Until 2001, when it joined the World Trade Organization, China imposed a 100 percent tariff on motor vehicle imports. The European Union imposes quotas on textile and apparel imports from China as a measure to protect European producers in southern Europe. India has a long history of utilizing excise taxes of as much as 50 percent on newly purchased products to protect its domestic producers. However, such duties were lowered to 8 to 14 percent in 2008 to help boost consumer demand to further accelerate India's overall economic growth rate.

Other governments, anxious to obtain new plants and jobs, offer foreign companies a helping hand in the form of subsidies, privileged market access, and technical assistance. All of these possibilities explain why the managers of companies opting to compete in foreign markets have to take a close look at a country's politics and its policies toward business in general, and toward foreign companies in particular, when deciding which country markets to participate in and which ones to avoid.

Strategy Options for Entering and Competing in Foreign Markets

There are several general strategic options for a company that decides to expand outside its domestic market and compete internationally or globally:

1. *Maintain a national (one-country) production base and export goods to foreign markets,* using either company owned or foreign-controlled forward distributionc hannels.
2. *License foreign firms to use the company's technology or to produce and distribute the company's products.*
3. *Employ a franchising strategy.*
4. *Follow a multicountry strategy,* varying the company's strategic approach (perhaps a little, perhaps a lot) from country to country in accordance with local conditions and differing buyer tastes and preferences.
5. *Follow a global strategy,* using essentially the same competitive strategy approach in all country markets where the company has a presence.
6. *Use strategic alliances or joint ventures with foreign companies as the primary vehicle for entering foreign markets* and perhaps also use them as an ongoing strategic arrangement aimed at maintaining or strengthening the company's competitiveness.

The following sections discuss the six general options in more detail.

ExportS trategies

Using domestic plants as a production base for exporting goods to foreign markets is an excellent initial strategy for pursuing international sales. It is a conservative way to test the international waters. The amount of capital needed to begin exporting is often quite minimal and existing production capacity may well be sufficient to make goods for export. With an export strategy, a manufacturer can limit its involvement in foreign markets by contracting with foreign wholesalers experienced in importing to handle the entire distribution and marketing function in their countries or regions of the world. If it is more advantageous to maintain control over these functions, however, a manufacturer can establish its own distribution and sales organizations in some or all of the target foreign markets. Either way, a home-based production and export strategy helps the firm minimize its direct investments in foreign countries.

An export strategy is vulnerable when (1) manufacturing costs in the home country are substantially higher than in foreign countries where rivals have plants, (2) the costs of shipping the product to distant foreign markets are relatively high, or (3) adverse shifts occur in currency exchange rates. Unless an exporter can both keep its production and shipping costs competitive with rivals and successfully hedge against unfavorable changes in currency exchange rates, its success will be limited.

LicensingS trategies

Licensing makes sense when a firm with valuable technical know-how or a unique patented product has neither the internal organizational capability nor the resources to enter foreign markets. Licensing also has the advantage of avoiding the risks of committing resources to country markets that are unfamiliar, politically volatile, economically unstable, or otherwise risky. By licensing the technology or the production rights to foreign-based firms, the firm does not have to bear the costs and risks of entering foreign markets on its own, yet it is able to generate income from royalties. The big disadvantage of licensing is the risk of providing valuable technological know-how to foreign companies and thereby losing some degree of control over its use. Also, monitoring licensees and safeguarding the company's proprietary know-how can prove quite difficult in some circumstances. But if the royalty potential is considerable and the companies to whom the licenses are being granted are both trustworthy and reputable, then licensing can be a very attractive option. Many software and pharmaceutical companies use licensing strategies.

Franchising Strategies

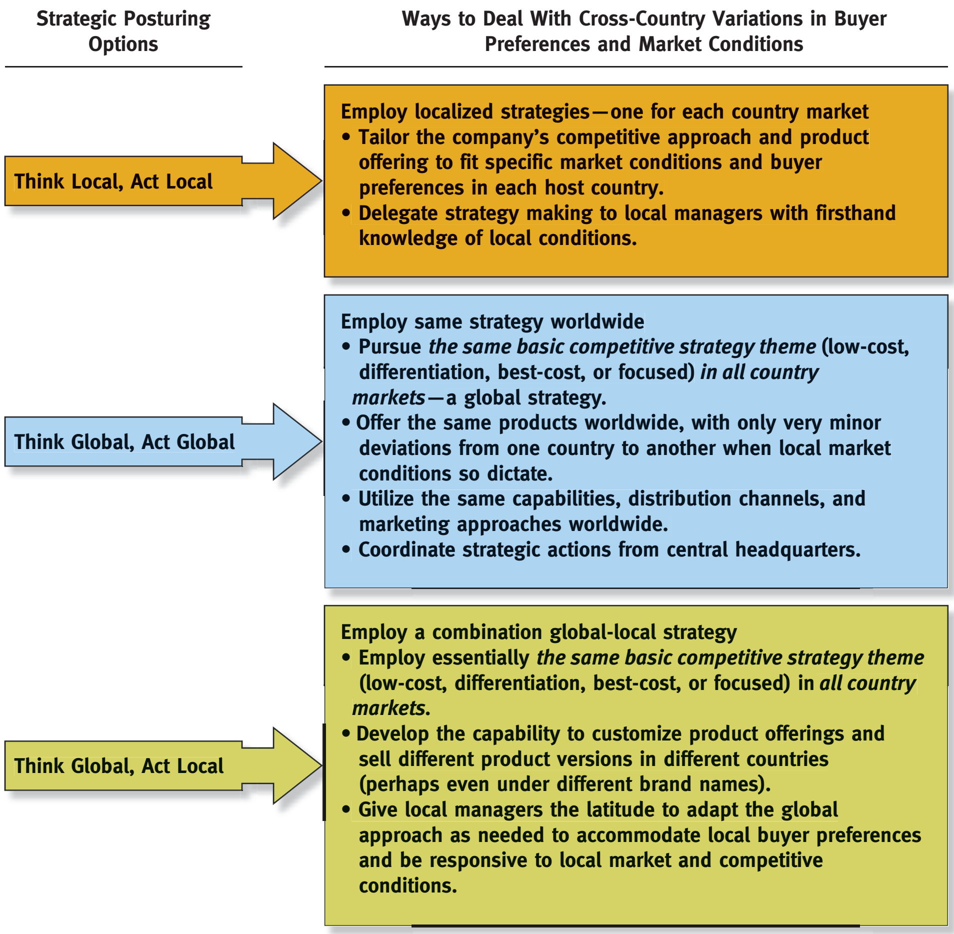
While licensing works well for manufacturers and owners of proprietary technology, franchising is often better suited to the global expansion efforts of service and retailing enterprises. McDonald's, Yum! Brands (the parent of A&W, Pizza Hut, KFC, Long John Silver's, and Taco Bell), the UPS Store, 7-Eleven, and Hilton Hotels have all used franchising to build a presence in international markets. Franchising has much the same advantages as licensing. The franchisee bears most of the costs and risks of establishing foreign locations, so a franchisor has to expend only the resources to recruit, train, support, and monitor franchisees. The big problem a franchisor faces is maintaining quality control. In many cases, foreign franchisees do not always exhibit strong commitment to consistency and standardization—especially when the local culture does not stress the same kinds of quality concerns. Another problem that can arise is whether to allow foreign franchisees to make modifications to the franchisor's product offering to better satisfy the tastes and expectations of local buyers. Should McDonald's allow its franchised units in Japan to modify Big Macs slightly to suit Japanese tastes? Should the franchised KFC units in China be permitted to substitute spices that appeal to Chinese consumers? Or should the same menu offerings be rigorously and unvaryingly required of all franchiseesw orldwide?

Establishing International Operations: Choosing between Localized Multicountry Strategies and a Global Strategy

While exporting, licensing, and franchising rely upon the competencies and capabilities of allies in international markets to deliver goods or services to buyers, companies pursuing international expansion may elect to take responsibility for the performance of all essential value chain activities in foreign markets. Once a company chooses to establish operations in international markets, deciding upon the degree to vary its competitive approach to fit specific market conditions and buyer preferences in each host country is perhaps the foremost strategic issue that it must address. Figure 7.1 shows a company's options for resolving this issue.

THINK LOCAL, ACT LOCAL APPROACHES TO STRATEGY MAKING A think local, act local approach to strategy making is essential when there are significant country-to-country differences in customer preferences and buying habits, when there are significant cross-country differences in distribution channels and marketing methods, when host governments enact regulations requiring that products sold locally meet strict manufacturing specifications or performance standards, and when the trade restrictions of host governments are so diverse and complicated that they preclude a uniform, coordinated worldwide market approach. With localized strategies, a company often has different product versions for different countries and sometimes sells the products under different brand names. Government requirements for gasoline additives that help reduce carbon monoxide, smog, and other emissions are almost never the same from country to country. BP utilizes localized strategies in its gasoline and service station business segment because of these cross-country formulation differences and because of customer familiarity with local brand names. For example, the company markets gasoline in the United States under its BP and Arco brands, but markets gasoline in Germany, Belgium, Poland, Hungary, and the Czech Republic under the Aral brand. In the food products industry, it is common for companies to vary the ingredients in their products and sell the localized versions under

FIGURE 7.1 **A Company's Strategic Options for Dealing with Cross-Country Variations in Buyer Preferences and Market Conditions**



local brand names in order to cater to country-specific tastes and eating preferences. The strength of employing a set of **localized or multicountry strategies** is that the company's actions and business approaches are deliberately crafted to appeal to the tastes and expectations of buyers in each country and to stake out the most attractive market positions vis-à-vis local competitors.[4]

> **Localized or multicountry strategies** are necessary when there are significant cross-country differences in customer preferences, buyer purchasing habits, distribution channels, or marketing methods. **Think local, act local** strategy-making approaches are also essential when host government regulations or trade policies preclude a uniform, coordinated worldwide market approach.

However, **think local, act local** strategies have two big drawbacks: (1) They hinder transfer of a company's competencies and resources across country boundaries because the strategies in different host countries can be grounded in varying competencies and capabilities; and (2) they do not promote building a single, unified competitive advantage—especially one based on low cost. Companies employing highly localized or multicountry strategies face big hurdles in achieving low-cost

[4] For more details on the merits of and opportunities for cross-border transfer of successful strategy experiments, see C. A. Bartlett and S. Ghoshal, *Managing Across Borders: The Transnational Solution*, 2nd ed. (Boston: Harvard Business School Press, 1998), pp. 79–80 and Chapter 9.

leadership *unless* they find ways to customize their products and *still* be in a position to capture scale economies and learning-curve effects. Toyota's unique mass customization production capability has been key to its ability to effectively adapt product offerings to local buyer tastes, while maintaining low-costl eadership.

THINK GLOBAL, ACT GLOBAL APPROACHES TO STRATEGY MAKING While multicountry or localized strategies are best suited for industries where a fairly high degree of local responsiveness is important, global strategies are best suited for globally standardized industries. A **global strategy** is one in which the company's approach is predominantly the same in all countries—it sells the same products under the same brand names everywhere, utilizes much the same distribution channels in all countries, and competes on the basis of the same capabilities and marketing approaches worldwide. Although the company's strategy or product offering may be adapted in very minor ways to accommodate specific situations in a few host countries, the company's fundamental competitive approach (low-cost, differentiation, or focused) remains very much intact worldwide and local managers stick close to the global strategy. A **think global, act global** strategic theme prompts company managers to integrate and coordinate the company's strategic moves worldwide and to expand into most if not all nations where there is significant buyer demand. It puts considerable strategic emphasis on building a *global* brand name and aggressively pursuing opportunities to transfer ideas, new products, and capabilities from one country to another.

Global strategies are best suited to industries that are globally standardized in terms of customer preferences, buyer purchasing habits, distribution channels, or marketing methods.

Ford's global design strategy is a move toward a think global, act global strategy by the company and involves the development and production of standardized models with country-specific modifications limited primarily to what is required to meet local country emission and safety standards. The 2010 Ford Fiesta and 2011 Ford Focus will be the company's first global design models and will be marketed in Europe, North America, Asia, and Australia. Whenever country-to-country differences are small enough to be accommodated within the framework of a global strategy, a global strategy is preferable to localized strategies because a company can more readily unify its operations and focus on establishing a brand image and reputation that is uniform from country to country. Moreover, with a global strategy a company is better able to focus its full resources on securing a sustainable low-cost or differentiation-based competitive advantage over both domestic rivals and global rivals.

THINK GLOBAL, ACT LOCAL APPROACHES TO STRATEGY MAKING Often, a company can accommodate cross-country variations in buyer tastes, local customs, and market conditions with a **think global, act local** approach to developing strategy. This middle-ground approach entails utilizing the same basic competitive theme (low-cost, differentiation, or

Think global, act locals trategy-making approaches involve employing essentially the same strategic theme (low-cost, differentiation, focused, best-cost) in all country markets, while allowing some country-to-country customization to fit local market conditions.

focused) in each country but allows local managers the latitude to (1) incorporate whatever country-specific variations in product attributes are needed to best satisfy local buyers and (2) make whatever adjustments in production, distribution, and marketing are needed to respond to local market conditions and compete successfully against local rivals. Slightly different product versions sold under the same brand name may suffice to satisfy local tastes, and it may be feasible to accommodate these versions rather economically in the course of designing and manufacturing the company's product offerings. Philip Morris International markets brands such as Marlboro, Chesterfield, Parliament, and Virginia Slims worldwide. However, the company also makes different versions of Marlboro cigarettes available in different parts of the world to better meet the somewhat different preferences and habits of smokers in each market. The company's Marlboro Mix 9 is a high-nicotine, clove-infused cigarette sold in Indonesia where smokers prefer powerful, sweet-smelling cigarettes. Its Marlboro Intense was formulated for the Turkish market, while its smooth-tasting Marlboro Filter Plus caters to the tastes of smokers in South Korea, Russia, Kazakhstan, and the Ukraine.

As a rule, most companies that operate multinationally endeavor to employ as global a strategy as customer needs and market conditions permit. Electronic Arts has two major design studios—one in Vancouver, British Columbia, and one in Los Angeles—and smaller design studios in San Francisco, Orlando, London, and Tokyo. This dispersion of design studios helps EA to design games that are specific to different cultures—for example, the London studio took the lead in designing the popular FIFA Soccer game to suit European tastes and to replicate the stadiums, signage, and team rosters; the U.S. studio took the lead in designing games involving NFL football, NBA basketball, and NASCAR racing.

Using International Strategic Alliances and Joint Ventures to Build Competitive Strength in Foreign Markets

Strategic alliances, joint ventures, and other cooperative agreements with foreign companies are a favorite and potentially fruitful means for entering a foreign market or strengthening a firm's competitiveness in world markets.[5] Historically, export-minded firms in industrialized nations sought alliances with firms in less-developed countries to import and market their products locally—such arrangements were often necessary to win approval for entry from the host country's government. Both Japanese and American companies are actively forming alliances with European companies to strengthen their ability to compete in the 27-nation European Union (and the three countries that are candidates to become EU members) and to capitalize on the opening up of Eastern European markets. Many U.S. and European companies are allying with Asian companies in their efforts to enter markets in China, India,

[5] For two especially insightful studies of company experiences with cross-border alliances, see Joel Bleeke and David Ernst, "The Way to Win in Cross-Border Alliances," *Harvard Business Review* 69, no. 6 (November–December 1991), pp. 127–135; and Gary Hamel, Yves L. Doz, and C. K. Prahalad, "Collaborate with Your Competitors—and Win," *Harvard Business Review* 67, no. 1 (January–February 1989), pp. 133–139.

Malaysia, Thailand, and other Asian countries. Many foreign companies, of course, are particularly interested in strategic partnerships that will strengthen their ability to gain a foothold in the U.S. market.

However, cooperative arrangements between domestic and foreign companies have strategic appeal for reasons besides gaining better access to attractive country markets.[6] A second big appeal of cross-border alliances is to capture economies of scale in production and/or marketing. By joining forces in producing components, assembling models, and marketing their products, companies can realize cost savings not achievable with their own small volumes. A third motivation for entering into a cross-border alliance is to fill gaps in technical expertise and/or knowledge of local markets (buying habits and product preferences of consumers, local customs, and so on). Allies learn much from one another in performing joint research, sharing technological know-how, studying one another's manufacturing methods, and understanding how to tailor sales and marketing approaches to fit local cultures and traditions. Indeed, one of the win-win benefits of an alliance is to learn from the skills, technological know-how, and capabilities of alliance partners and implant the knowledge and know-how of these partners in personnel throughout the company.

A fourth motivation for cross-border alliances is to share distribution facilities and dealer networks, and to mutually strengthen each partner's access to buyers. A fifth benefit is that cross-border allies can direct their competitive energies more toward mutual rivals and less toward one another; teaming up may help them close the gap on leading companies. A sixth driver of cross-border alliances comes into play when companies wanting to enter a new foreign market conclude that alliances with local companies are an effective way to establish working relationships with key officials in the host-country government.[7] And, finally, alliances can be a particularly useful way for companies across the world to gain agreement on important technical standards—they have been used to arrive at standards for assorted PC devices, Internet-related technologies, high-definition televisions, and mobile phones.

What makes cross-border alliances an attractive strategic means of gaining the aforementioned types of benefits (as compared to acquiring or merging with foreign-based companies) is that entering into alliances and strategic partnerships allows a company to preserve its independence and avoid using perhaps scarce financial resources to fund acquisitions. Furthermore, an alliance offers the flexibility to readily disengage once its purpose has been served or if the benefits prove elusive, whereas an acquisition is a more permanent sort of arrangement.[8] Concepts & Connections 7.1 provides examples of cross-border strategic alliances.

[6] See Yves L. Doz and Gary Hamel, *Alliance Advantage* (Boston, MA: Harvard Business School Press, 1998), especially Chapters 2–4; Bleeke and Ernst, "The Way to Win in Cross-Border Alliances," pp. 127–133; Hamel, Doz, and Prahalad, "Collaborate with Your Competitors—and Win," pp. 134–135; and Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990), p. 66.

[7] H. Kurt Christensen, "Corporate Strategy: Managing a Set of Businesses," in *The Portable MBA in Strategy*, ed. Liam Fahey and Robert M. Randall (New York: Wiley, 2001), p. 43.

[8] For an excellent presentation on the pros and cons of alliances versus acquisitions, see Jeffrey H. Dyer, Prashant Kale, and Harbir Singh, "When to Ally and When to Acquire," *Harvard Business Review* 82, no. 7/8 (July–August 2004), pp. 109–115.

Concepts & Connections 7.1

EXAMPLES OF CROSS-BORDER STRATEGIC ALLIANCES

1. Verio, a subsidiary of Japan-based NTT Communications and one of the leading global providers of Web hosting services and IP data transport, has developed an alliance-oriented business model that combines the company's core competencies with the skills and products of best-of-breed technology partners. Verio's strategic partners include Arsenal Digital Solutions (a provider of worry-free tape backup, data restore, and data storage services), Internet Security Systems (a provider of firewall and intrusion detection systems), and Mercantec (which develops storefront and shopping cart software). Verio management believes that its portfolio of strategic alliances allows it to use innovative, best-of-class technologies in providing its customers with fast, efficient, accurate data transport and a complete set of Web hosting services. An independent panel of 12 judges recently selected Verio as the winner of the Best Technology Foresight Award for its efforts in pioneering new technologies.
2. A 2003 strategic alliance between British oil producer BP and Russia's Alfa, Access, Renova (AAR) oil and gas producer has produced Russia's third-largest crude oil producer. The strategic alliance provided BP with access to AAR's vast oil reserves and allowed AAR access to BP's assets in Russia, including BP's retail refined gasoline network. The addition of BP's oil field production expertise increased the field production by 250 percent between 2003 and 2007. BP exploration and drilling capabilities also contributed to the development of new greenfield projects that were expected to come online in 2009.
3. Toyota and First Automotive Works, China's biggest automaker, entered into an alliance in 2002 to make luxury sedans, sport-utility vehicles, and minivehicles for the Chinese market. The intent was to make as many as 400,000 vehicles annually by 2010, an amount equal to the number that Volkswagen, the company with the largest share of the Chinese market, was making as of 2002. The alliance envisioned a joint investment of about $1.2 billion. At the time of the announced alliance, Toyota was lagging behind Honda, General Motors, and Volkswagen in setting up production facilities in China. Capturing a bigger share of the Chinese market was seen as crucial to Toyota's success in achieving its strategic objective of having a 15 percent share of the world's automotive market by 2010.
4. European Aeronautic Defence and Space Company (EADS) was formed by an alliance of aerospace companies from Britain, Spain, Germany, and France that included British Aerospace, Daimler-Benz Aerospace, and Aerospatiale. The objective of the alliance was to create a European aircraft company capable of competing with U.S.-based Boeing Corp. The alliance has proved highly successful, infusing its commercial airline division, Airbus, with the know-how and resources to compete head-to-head with Boeing for world leadership in large commercial aircraft (over 100 passengers). The company also established an alliance with U.S. military aircraft manufacturer Northrop Grumman to develop a highly sophisticated refueling tanker based upon the A330 airliner.

Sources: Company Web sites and press releases.

THE RISKS OF STRATEGIC ALLIANCES WITH FOREIGN PARTNERS Alliances and joint ventures with foreign partners have their pitfalls, however. Cross-border allies typically have to overcome language and cultural barriers and figure out how to deal with diverse (or perhaps conflicting) operating practices. The communication, trust-building, and coordination costs are high in terms of management time.[9] It is not unusual for partners to discover they have conflicting objectives and strategies, deep differences of opinion about how to proceed, or important differences in corporate values and ethical standards. Tensions build up, working relationships cool, and the hoped-for benefits never materialize. The recipe for successful alliances requires many meetings of many people working in good faith over a period of time to iron out what is to be shared, what is to remain proprietary, and how the cooperative arrangements will work.[10]

Even if the alliance becomes a win-win proposition for both parties, there is the danger of becoming overly dependent on foreign partners for essential expertise and competitive capabilities. If a company is aiming for global market leadership and needs to develop capabilities of its own, then at some juncture cross-border merger or acquisition may have to be substituted for cross-border alliances and joint ventures. One of the lessons about cross-border alliances is that they are more effective in helping a company establish a beachhead of new opportunity in world markets than they are in enabling a company to achieve and sustain global market leadership.

Using International Operations to Improve Overall Competitiveness

There are three important ways in which a firm can gain competitive advantage by expanding outside its domestic market.[11] One, it can use location to lower costs or help achieve greater product differentiation. Two, it can use cross-border coordination in ways that a domestic-only competitor cannot. And three, it can use profit sanctuaries to wage a strategic offensive.

Using Location to Build Competitive Advantage

To use location to build competitive advantage, a company must consider two issues: (1) whether to concentrate each internal process in a few countries or to disperse performance of each process to many nations, and (2) in which countries to locate particular activities.[12]

WHEN TO CONCENTRATE INTERNAL PROCESSES IN A FEW LOCATIONS Companies tend to concentrate their activities in a limited number of locations in the following circumstances:

- *When the costs of manufacturing or other activities are significantly lower in some geographic locations than in others*—For example, much of the world's athletic footwear is manufactured in Asia (China and Korea) because of low labor costs; much of the production of circuit boards for PCs is

[9] For additional discussion of company experiences with alliances and partnerships, see Doz and Hamel, *Alliance Advantage*, Chapters 2–7; and Rosabeth Moss Kanter, "Collaborative Advantage: The Art of the Alliance," *Harvard Business Review* 72, no. 4 (July–August 1994), pp. 96–108.

[10] Jeremy Main, "Making Global Alliances Work," *Fortune*, December 19, 1990, p. 125.

[11] Porter, *The Competitive Advantage of Nations*, pp. 53–55.

[12] Ibid., pp. 55–58.

located in Taiwan because of both low costs and the high-caliber technical skills of the Taiwanese labor force.

- *When there are significant scale economies*—The presence of significant economies of scale in components production or final assembly means that a company can gain major cost savings from operating a few superefficient plants as opposed to a host of small plants scattered across the world. Makers of digital cameras and LCD TVs located in Japan, South Korea, and Taiwan have used their scale economies to establish a low-cost advantage.
- *When there is a steep learning curve associated with performing an activity*—In some industries learning-curve effects in parts manufacture or assembly are so great that a company establishes one or two large plants from which it serves the world market. The key to riding down the learning curve is to concentrate production in a few locations to increase the accumulated volume at a plant (and thus the experience of the plant's workforce) as rapidly as possible.
- *When certain locations have superior resources, allow better coordination of related activities, or offer other valuable advantages*—A research unit or a sophisticated production facility may be situated in a particular nation because of its pool of technically trained personnel. Samsung became a leader in memory chip technology by establishing a major R&D facility in Silicon Valley and transferring the know-how it gained back to headquarters and its plants in South Korea.

Companies that compete multinationally can pursue competitive advantage in world markets by locating their value chain activities in whichever nations prove most advantageous.

WHEN TO DISPERSE INTERNAL PROCESSES ACROSS MANY LOCATIONS There are several instances when dispersing a process is more advantageous than concentrating it in a single location. Buyer-related activities—such as distribution to dealers, sales and advertising, and after-sale service—usually must take place close to buyers. This makes it necessary to physically locate the capability to perform such activities in every country market where a global firm has major customers. For example, the four biggest public accounting firms have numerous international offices to service the foreign operations of their multinational corporate clients. Dispersing activities to many locations is also competitively important when high transportation costs, diseconomies of large size, and trade barriers make it too expensive to operate from a central location. In addition, it is strategically advantageous to disperse activities to hedge against the risks of fluctuating exchange rates and adverse political developments.

Using Cross-Border Coordination to Build Competitive Advantage

Multinational and global competitors are able to coordinate activities across different countries to build competitive advantage.[13] If a firm learns how to assemble its product more efficiently at, say, its Brazilian plant, the accumulated expertise and knowledge can be shared with assembly plants

[13] C. K. Prahalad and Yves L. Doz, *The Multinational Mission* (New York: Free Press, 1987), pp. 58–60.

in other world locations. Also, knowledge gained in marketing a company's product in Great Britain, for instance, can readily be exchanged with company personnel in New Zealand or Australia. Other examples of cross-border coordination include shifting production from a plant in one country to a plant in another to take advantage of exchange rate fluctuations and to respond to changing wage rates, energy costs, or changes in tariffs and quotas.

Efficiencies can also be achieved by shifting workloads from where they are unusually heavy to locations where personnel are underutilized. Whirlpool's efforts to link its product R&D and manufacturing operations in North America, Latin America, Europe, and Asia allowed it to accelerate the discovery of innovative appliance features, coordinate the introduction of these features in the appliance products marketed in different countries, and create a cost-efficient worldwide supply chain. Whirlpool's conscious efforts to integrate and coordinate its various operations around the world have helped it become a low-cost producer and also speed product innovations to market, thereby giving Whirlpool an edge over rivals worldwide.

Using Profit Sanctuaries to Wage a Strategic Offensive

Profit sanctuaries are country markets (or geographic regions) in which a company derives substantial profits because of its strong or protected market position. Nike, which markets its products in 160 countries, has two big profit sanctuaries: the United States (where it earned 35.5 percent of its pretax profits in 2008), and Europe, the Middle East, and Africa (where it earned 32.2 percent of 2008 pretax profits). Carrefour, the world's second largest retailer with over 15,000 stores in Europe, Asia, and the Americas, also has two principal profit sanctuaries: its biggest is in France (which in 2008 accounted for 41.9 percent of earnings before interest and taxes) and its second biggest is in Europe outside of France (which in 2008 accounted for 35.9 percent of earnings before interest and taxes). Japan is the chief profit sanctuary for most Japanese companies because trade barriers erected by the Japanese government effectively block foreign companies from competing for a large share of Japanese sales. Protected from the threat of foreign competition in their home market, Japanese companies can safely charge somewhat higher prices to their Japanese customers and thus earn attractively large profits on sales made in Japan. In most cases, a company's biggest and most strategically crucial profit sanctuary is its home market, but international and global companies may also enjoy profit sanctuary status in other nations where they have a strong competitive position, big sales volume, and attractive profit margins.

Profit sanctuaries are valuable competitive assets, providing the financial strength to support strategic offensives in selected country markets and fuel a company's race for global market leadership. The added financial capability afforded by multiple profit sanctuaries gives a global or multicountry competitor the financial strength to wage a market offensive against a domestic competitor. The global company has the flexibility of low-balling its prices or launching high-cost marketing campaigns in the domestic company's home market and grabbing market share at the domestic company's expense. Razor-thin margins or even losses in these markets can be subsidized with the healthy profits earned in its profit sanctuaries. If the domestic company retaliates with matching price cuts or increased marketing expenses, its profits can be squeezed substantially and its competitive strength sapped, even if it is the domestic market leader.

When taken to the extreme, cut-rate pricing attacks by multicountry competitors may draw charges of unfair dumping. A company is said to be dumping when it sells its goods in foreign markets at prices that are (1) well below the prices at which it normally sells in its home market or (2) well below its full costs per unit. Companies that engage in dumping usually keep their selling prices high enough to cover variable costs per unit, thereby limiting their losses on each unit to some percentage of fixed costs per unit.

Dumping can be a tempting offensive strategy in either of two instances. The first may be justified as a legitimate competitive practice, while the latter is usually viewed to be predatory in nature. A charge of unfair dumping is more easily defended when a company with unused production capacity discovers that it is cheaper to keep producing (as long as the selling prices cover average variable costs per unit) than it is to incur the costs associated with idle plant capacity. By keeping its plants operating at or near capacity, not only may a dumping company be able to cover variable costs and earn a contribution to fixed costs, but it also may be able to use its below-market prices to draw price-sensitive customers away from foreign rivals. It is wise for companies pursuing such an approach to court these new customers and retain their business when prices later begin a gradual rise back to normal market levels.

A company may use dumping to drive down the price so far in the targeted country that domestic firms are quickly put in dire financial straits or in danger of being driven out of business. However, using below-market pricing in this way runs a high risk of host government retaliation on behalf of the adversely affected domestic companies. Indeed, as the trade among nations has mushroomed over the past 10 years, most governments have joined the World Trade Organization (WTO), which promotes fair trade practices among nations and actively polices dumping. Most WTO member governments have enacted antidumping laws and readily take action against dumping wherever there is material injury to domestic competitors. Companies based in France and China were recently found guilty of dumping laminate flooring at unreasonably low prices in Canada to the detriment of Canadian producers.[14] Most all governments can be expected to retaliate against dumping by imposing special tariffs on goods being imported from the countries of the guilty companies. Companies deemed guilty of dumping frequently come under pressure from their government to cease and desist, especially if the tariffs adversely affect innocent companies based in the same country or if the advent of special tariffs raises the specter of a trade war.

Strategies to Compete in the Markets of Emerging Countries

Companies racing for global leadership have to consider competing in emerging markets like China, India, Brazil, Indonesia, Thialand, Poland, Russia, and Mexico—countries where the business risks are considerable but where the

[14] Canadian International Trade Tribunal, findings issued June 16, 2005, and posted at www.citt-tcce.gc.ca (accessed September 28, 2005).

opportunities for growth are huge, especially as their economies develop and living standards climb toward levels in the industrialized world.[15] For example, in 2008 China was the world's second largest economy (behind the United States) based upon purchasing power. Its population of 1.3 billion people consumed nearly 33 percent of the world's annual cotton production, 51 percent of the world's pork, 35 percent of all cigarettes, 23 percent of televisions, 20 percent of cell phones, and 18 percent of the washing machines produced worldwide in 2003. China is also the world's largest consumer of many commodities—accounting for one-half of the world's demand for cement, a third of all steel produced, 31 percent of worldwide coal production, and over 25 percent of the world's aluminum purchases. China's growth in demand for consumer goods has put it on track to become the second largest market for motor vehicles by 2010 and the world's largest market for luxury goods by 2014.[16] Concepts & Connections 7.2 describes Yum! Brands' strategy to boost its sales and market share in China.

Tailoring products to fit conditions in an emerging country market like China, however, often involves more than making minor product changes and becoming more familiar with local cultures.[17] McDonald's has had to offer vegetable burgers in parts of Asia and to rethink its prices, which are often high by local standards and affordable only by the well-to-do. Kellogg has struggled to introduce its cereals successfully because consumers in many less-developed countries do not eat cereal for breakfast—changing habits is difficult and expensive. Single-serving packages of detergents, shampoos, pickles, cough syrup, and cooking oils are very popular in India because they allow buyers to conserve cash by purchasing only what they need immediately. Thus, many companies find that trying to employ a strategy akin to that used in the markets of developed countries is hazardous.[18] Experimenting with some, perhaps many, local twists is usually necessary to find a strategy combination that works.

Strategy Options for Emerging-Country Markets

Several strategy options for tailoring a company's strategy to fit the sometimes unusual or challenging circumstances presented in emerging country markets are the following:

- *Prepare to compete on the basis of low price.* Consumers in emerging markets are often highly focused on price, which can give low-cost local competitors the edge unless a company can find ways to attract buyers with

[15]This point is discussed at greater length in Prahalad and Lieberthal, "The End of Corporate Imperialism," pp. 68–79; also, see David J. Arnold and John A. Quelch, "New Strategies in Emerging Markets," *Sloan Management Review* 40, no. 1 (Fall 1998), pp. 7–20. For a more extensive discussion of strategy in emerging markets, see C. K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profits* (Upper Saddle river, NJ: Wharton, 2005), especially Chapters 1–3.

[16] Brenda Cherry, "What China Eats (and Drinks and . . .)," *Fortune*, October 4, 2004, pp. 152–153; "A Ravenous Dragon," *The Economist* 386, no. 8571 (March 15, 2008), online edition; and "China: Just the Facts," *Journal of Commerce*, June 2, 2008, p. 24.

[17] Prahalad and Lieberthal, "The End of Corporate Imperialism," pp. 72–73.

[18] Tarun Khanna, Krishna G. Palepu, and Jayant Sinha, "Strategies That Fit Emerging Markets," *Harvard Business Review* 83, no. 6 (June 2005), p. 63; and Arindam K. Bhattacharya and David C. Michael, "How Local Companies Keep Multinationals at Bay," *Harvard Business Review* 86, no. 3 (March 2008), pp. 94–95.

Concepts & Connections 7.2

YUM! BRANDS' STRATEGY FOR BECOMING THE LEADING FOOD SERVICE BRAND IN CHINA

In 2009, Yum! Brands operated more than 36,000 restaurants in more than 110 countries. Its best known brands were KFC, Taco Bell, Pizza Hut, and Long John Silver's. Its fastest revenue growth in 2008 came from its 3,100 restaurants in China, which recorded operating profits of $469 million during the year. KFC was the largest quick-service chain in China with 2,600 units in 2009, while Pizza Hut was the largest casual dining chain with more than 500 units. Yum! planned to open at least 425 new restaurant locations annually in China, including new Pizza Hut Home delivery units and East Dawning units, which had a menu offering traditional Chinese food. All of Yum! Brands' menu items for China were developed in its R&D facility in Shanghai.

In addition to adapting its menu to local tastes and adding new units at a rapid pace, Yum! Brands also adapted the restaurant ambiance and décor to appeal to local consumer preferences and behavior. The company changed its KFC store formats to provide educational displays that supported parents' priorities for their children and to make KFC a fun place for children to visit. The typical KFC outlet in China averaged two birthday parties per day.

In 2009, Yum! Brands operated 60 KFC, Taco Bell, Pizza Hut, A&W and Long John Silver's restaurants for every 1 million Americans. The company's 3,100 units in China represented only two restaurants per 1 million people in China. Yum! Brands management believed that its strategy keyed to continued expansion in the number of units in China and additional menu refinements would allow its operating profits from restaurants located in China to account for 40 percent of systemwide operating profits by 2017.

Sources: Yum! Brands 2007 10-K; information posted at www.yum.com.

bargain prices as well as better products.[19] For example, when Unilever entered the market for laundry detergents in India, it developed a low-cost detergent (named Wheel) that was not harsh to the skin, constructed new superefficient production facilities, distributed the product to local merchants by hand carts, and crafted an economical marketing campaign that included painted signs on buildings and demonstrations near stores—the new brand quickly captured $100 million in sales and was the number-one detergent brand in India in 2008 based on dollar sales. Unilever later replicated the strategy with low-priced shampoos and deodorants in India and in South America with a detergent brand named Ala.

- *Be prepared to modify aspects of the company's business model or strategy to accommodate local circumstances (but not so much that the company loses the advantage of global scale and global branding).*[20] For instance when Dell entered China, it discovered that individuals and businesses were not accustomed to placing orders via the Internet (in North America, over 50 percent of Dell's sales in 2002–2008 were made online). To adapt, Dell modified its direct sales model to rely more heavily on phone and fax orders and decided to be patient in getting Chinese customers to place Internet orders. Further, because numerous Chinese government

[19] Prahalad and Lieberthal, "The End of Corporate Imperialism," p. 72.
[20] Khanna, Palepu, and Sinha, "Strategies That Fit Emerging Markets," pp. 73–74.

departments and state-owned enterprises insisted that hardware vendors make their bids through distributors and systems integrators (as opposed to dealing directly with Dell salespeople as did large enterprises in other countries), Dell opted to use third parties in marketing its products to this buyer segment (although it did sell through its own sales force where it could). But Dell was careful not to abandon those parts of its business model that gave it a competitive edge over rivals.

- *Try to change the local market to better match the way the company does business elsewhere.*[21] A multinational company often has enough market clout to drive major changes in the way a local country market operates. When Japan's Suzuki entered India in 1981, it triggered a quality revolution among Indian auto parts manufacturers. Local parts and components suppliers teamed up with Suzuki's vendors in Japan and worked with Japanese experts to produce higher-quality products. Over the next two decades, Indian companies became very proficient in making top-notch parts and components for vehicles, won more prizes for quality than companies in any country other than Japan, and broke into the global market as suppliers to many automakers in Asia and other parts of the world. Mahindra and Mahindra, one of India's premier automobile manufacturers, has been recognized by a number of organizations for its product quality. Among its most noteworthy awards was its number-one ranking by J.D. Power Asia Pacific in 2007 for new vehicle overall quality.
- *Stay away from those emerging markets where it is impractical or uneconomical to modify the company's business model to accommodate local circumstances.*[22] Home Depot expanded into Mexico in 2001 and China in 2006, but has avoided entry into other emerging countries because its value proposition of good quality, low prices, and attentive customer service relies on (1) good highways and logistical systems to minimize store inventory costs, (2) employee stock ownership to help motivate store personnel to provide good customer service, and (3) high labor costs for housing construction and home repairs to encourage homeowners to engage in do-it-yourself projects. Relying on these factors in the U.S. and Canadian markets has worked spectacularly for Home Depot, but Home Depot has found that it cannot count on these factors in nearby Latin America.

Company experiences in entering developing markets like China, India, Russia, and Brazil indicate that profitability seldom comes quickly or easily. Building a market for the company's products can often turn into a long-term process that involves reeducation of consumers, sizable investments in advertising and promotion to alter tastes and buying habits, and upgrades of the local infrastructure (the supplier base, transportation systems, distribution channels, labor markets, and capital markets). In such cases, a company must be patient, work within the system to improve the infrastructure, and lay the foundation for generating sizable revenues and profits once conditions are ripe for market take-off.

Profitability in emerging markets rarely comes quickly or easily—new entrants have to adapt their business models and strategies to local conditions and be patient in earning a profit.

[21] Ibid., p. 74.
[22] Ibid., p. 76.

KeyP oints

1. Competing in international markets allows multinational companies to (1) gain access to new customers, (2) achieve lower costs and enhance the firm's competitiveness by more easily capturing scale economies or learning-curve effects, (3) leverage core competencies refined domestically in additional country markets, and (4) spread business risk across a wider market base.
2. Companies electing to expand into international markets must consider cross-country differences in cultural, demographic, and market conditions, location-based cost drivers, adverse exchange rates, and host government policies when evaluating strategy options.
3. In posturing to compete in foreign markets, a company has three basic options: (1) a think local, act local approach to crafting a strategy, (2) a think global, act global approach to crafting a strategy, and (3) a combination think global, act local approach. A "think local, act local" or multicountry strategy is appropriate for industries or companies that must vary their product offerings and competitive approaches from country to country in order to accommodate differing buyer preferences and market conditions. A "think global, act global" approach (or global strategy) works best in markets that support employing the same basic competitive approach (low-cost, differentiation, focused) in all country markets and marketing essentially the same products under the same brand names in all countries where the company operates. A "think global, act local" approach can be used when it is feasible for a company to employ essentially the same basic competitive strategy in all markets, but still customize its product offering and some aspect of its operations to fit local market circumstances.
4. Other strategy options for competing in world markets include maintaining a national (one-country) production base and exporting goods to foreign markets, licensing foreign firms to use the company's technology or produce and distribute the company's products, employing a franchising strategy, and using strategic alliances or other collaborative partnerships to enter a foreign market or strengthen a firm's competitiveness in world markets.
5. Strategic alliances with foreign partners have appeal from several angles: gaining wider access to attractive country markets, allowing capture of economies of scale in production and/or marketing, filling gaps in technical expertise and/or knowledge of local markets, saving on costs by sharing distribution facilities and dealer networks, developing relationships with host country officials, helping gain agreement on important technical standards, and combating a common rival.
6. There are three general ways in which a firm can gain competitive advantage (or offset domestic disadvantages) in global markets. One way involves locating various value chain activities among nations in a manner that lowers costs or achieves greater product differentiation. A second way draws on a multinational or global competitor's ability to deepen or broaden its resource strengths and capabilities and to coordinate its dispersed activities in ways that a domestic-only competitor cannot. A third involves utilizing profit sanctuaries in protected markets to wage strategic offenses in various international markets. Profit sanctuaries are country markets in which a company derives substantial profits because of its strong or protected market position. They are valuable competitive assets. A company with multiple profit sanctuaries has the financial strength to support competitive offensives in one market with resources and profits diverted from its

operations in other markets. The ability of companies with multiple profit sanctuaries to employ cross-subsidization gives them a powerful offensive weapon and a competitive advantage over companies with a single sanctuary.

7. Companies racing for global leadership have to consider competing in emerging markets like China, India, Brazil, Indonesia, and Mexico—countries where the business risks are considerable but the opportunities for growth are huge. To succeed in these markets, companies often have to (1) compete on the basis of low price, (2) be prepared to modify aspects of the company's business model or strategy to accommodate local circumstances (but not so much that the company loses the advantage of global scale and global branding), and/or (3) try to change the local market to better match the way the company does business elsewhere. Profitability is unlikely to come quickly or easily in emerging markets, typically because of the investments needed to alter buying habits and tastes and/or the need for infrastructure upgrades. And there may be times when a company should simply stay away from certain emerging markets until conditions for entry are better suited to its business model and strategy.

Assurance of Learning Exercises

LO3 1. Harley-Davidson has chosen to compete in various country markets in Europe and Asia using an export strategy. Read the sections of its latest annual report at www.harley-davidson.com related to its international operations. Why does it seem the company has avoided developing production facilities outside the United States?

LO3 2. Assume you are in charge of developing the strategy for a multinational company selling products in some 50 different countries around the world. One of the issues you face is whether to employ a multicountry strategy or a global strategy.

   a. If your company's product is mobile phones, do you think it would make better strategic sense to employ a multicountry strategy or a global strategy? Why?
   b. If your company's product is dry soup mixes and canned soups, would a multicountry strategy seem to be more advisable than a global strategy? Why?
   c. If your company's product is large home appliances such as washing machines, ranges, ovens, and refrigerators, would it seem to make more sense to pursue a multicountry strategy or a global strategy? Why?
   d. If your company's product is apparel and footwear, would a multicountry strategy or a global strategy seem to have more appeal? Why?

LO3 3. The Hero Group is among the 10 largest corporations in India with 20 business segments and annual revenues of $3.2 billion in fiscal 2006. Many of the corporation's business units have utilized strategic alliances with foreign partners to compete in new product and geographic markets. Review the company's statements concerning its alliances and international business operations at www.herogroup.com/alliance.htm and prepare a two-page report that outlines the group's successful use of international strategic alliances.

Exercises for Simulation Participants

The questions below are for simulation participants whose companies operate in an international or global market arena. If your company competes only in a single country, then skip the questions in this section. LO2 LO3 LO4

1. Is the international market arena in which your company competes characterized by multicountry competition or global competition? Explain why.
2. Which of the strategies for competing in foreign markets is your company employing?
3. Which one of the following best describes the strategic approach your company is taking in try to compete successfully?
    - Thinkl ocal,ac tl ocal
    - Thinkg lobal,ac tl ocal
    - Thinkg lobal,ac tg lobal

    Explainyo uran swer.
4. To what extent, if any, have you and your co-managers adapted your company's strategy to take shifting exchange rates into account? In other words, have you undertaken any actions to try to minimize the impact of adverse shifts in exchanger ates?
5. To what extent, if any, have you and your co-managers adapted your company's strategy to take geographic differences in import tariffs or import duties into account?

Chapter 8

Strategies for Multibusiness Corporations

Chapter Learning Objectives

LO1. Understand when and how diversifying into multiple businesses can enhance shareholder value.

LO2. Gain an understanding of how related diversification strategies can produce cross-business strategic fits capable of delivering competitive advantage.

LO3. Become aware of the merits and risks of corporate strategies keyed to unrelated diversification.

LO4. Gain command of the analytical tools for evaluating a company's diversification strategy.

LO5. Become familiar with a company's main corporate strategy options after it has diversified.

In this chapter, we move up one level in the strategy-making hierarchy, from strategy making in a single-business enterprise to strategy making in a diversified enterprise. Because a diversified company is a collection of individual businesses, the strategy-making task is more complicated. In a one-business company, managers have to come up with a plan for competing successfully in only a single industry environment—the result is what we labeled in Chapter 2 as *business strategy* (or *business-level strategy*). But in a diversified company, the strategy-making challenge involves assessing multiple industry environments and developing a *set* of business strategies, one for each industry arena in which the diversified company operates. And top executives at a diversified company must still go one step further and devise a companywide or *corporate strategy* for improving the attractiveness and performance of the company's overall business lineup and for making a rational whole out of its diversified collection of individual businesses.

In most diversified companies, corporate-level executives delegate considerable strategy-making authority to the heads of each business, usually giving them the latitude to craft a business strategy suited to their particular industry and competitive circumstances and holding them accountable for producing good results. But the task of crafting a diversified company's overall corporate strategy falls squarely in the lap of top-level executives and involves four distinct facets:

1. *Picking new industries to enter and deciding on the means of entry*—The decision to pursue business diversification requires that management decide what new industries offer the best growth prospects and whether to enter by starting a new business from the ground up, acquiring a company already in the target industry, or forming a joint venture or strategic alliance with another company.
2. *Pursuing opportunities to leverage cross-business value chain relationships into competitive advantage*—Companies that diversify into businesses with strategic fit across the value chains of their business units have a much better chance of gaining a 1 + 1 = 3 effect than multibusiness companies lacking strategicf it.
3. *Steering corporate resources into the most attractive business units*—A diversified company's business units are usually not equally attractive and it is incumbent on corporate management to channel resources into areas where earnings potentials are higher.
4. *Initiating actions to boost the combined performance of the corporation's collection of businesses*—Corporate strategists must craft moves to improve the overall performance of the corporation's business lineup and sustain increases in shareholder value. Strategic options for diversified corporations include (a) sticking closely with the existing business lineup and pursuing opportunities presented by these businesses, (b) broadening the scope of diversification by entering additional industries, (c) retrenching to a narrower scope of diversification by divesting poorly performing businesses, and (d) broadly restructuring the business lineup with multiple divestitures and/or acquisitions.

In the first portion of this chapter we describe the various means a company can use to diversify and explore the pros and cons of related versus unrelated diversification strategies. The second part of the chapter looks at how to evaluate the attractiveness of a diversified company's business lineup, decide whether it has a good diversification strategy, and identify ways to improve its future performance.

When Business Diversification Becomes a Consideration

So long as a single-business company can achieve profitable growth opportunities in its present industry, there is no urgency to pursue diversification. The big risk of a single-business company, of course, is having all of the firm's eggs in one industry basket. If demand for the industry's product is eroded or if the industry becomes competitively unattractive and unprofitable, then a company's prospects can quickly dim. Consider, for example, what the growing use of debit cards and online bill payment have done to the check printing business; what iPods, other brands of digital music players, and online music stores have done to the business outlook for the retailers of music CDs; and what mobile phone companies and marketers of Voice over Internet Protocol (VoIP) have done to the revenues of long-distance providers such as AT&T, British Telecommunications, and NTT in Japan.

Thus, *diversifying into new industries always merits strong consideration whenever a single-business company encounters diminishing market opportunities and stagnating sales in its principal business.* But there are four other instances in which a company becomes a prime candidate for diversifying:[1]

1. When it spots opportunities for expanding into industries whose technologies and products complement its present business.
2. When it can leverage existing competencies and capabilities by expanding into industries where these same resource strengths are valuable competitiveas sets.
3. When diversifying into closely related businesses opens new avenues for reducingc osts.
4. When it has a powerful and well-known brand name that can be transferred to the products of other businesses.

The decision to diversify presents wide-ranging possibilities. A company can diversify into closely related businesses or into totally unrelated businesses. It can diversify its present revenue and earning base to a small or major extent (such that new businesses produce 30 or more percent of revenues and profits). It can move into one or two large new businesses or a greater number of small ones. It can achieve diversification by acquiring an existing company, starting up a new business subsidiary from scratch, or forming a joint venture with one or more companies to enter new businesses.

[1] For a further discussion of when diversification makes good strategic sense, see Constantinos C. Markides, "To Diversify or Not to Diversify," *Harvard Business Review* 75, no. 6 (November–December 1997), pp. 93–99.

Building Shareholder Value: The Ultimate Justification for Business Diversification

Diversification must do more for a company than simply spread its business risk across various industries. In principle, diversification cannot be considered a success unless it results in *added shareholder value*—value that shareholders cannot capture on their own by spreading their investments across the stocks of companies in different industries.

Business diversification stands little chance of building shareholder value without passing the following three tests:[2]

1. *The industry attractiveness test*—The industry to be entered through diversification must offer an opportunity for profits and return on investment that is equal to or better than that of the company's present business(es).
2. *The cost-of-entry test*—The cost to enter the target industry must not be so high as to erode the potential for good profitability. A catch-22 can prevail here, however. The more attractive an industry's prospects are for growth and good long-term profitability, the more expensive it can be to enter. It's easy for acquisitions of companies in highly attractive industries to fail the cost-of-entry test.
3. *The better-off test*—Diversifying into a new business must offer potential for the company's existing businesses and the new business to perform better together under a single corporate umbrella than they would perform operating as independent, standalone businesses. For example, let's say that company A diversifies by purchasing company B in another industry. If A and B's consolidated profits in the years to come prove no greater than what each could have earned on its own, then A's diversification won't provide its shareholders with added value. Company A's shareholders could have achieved the same 1 + 1 = 2 result by merely purchasing stock in company B. Shareholder value is not created by diversification unless it produces a 1 + 1 = 3 effect.

Creating added value for shareholders via diversification requires building a multibusiness company where the whole is greater than the sum of its parts

Diversification moves that satisfy all three tests have the greatest potential to grow shareholder value over the long term. Diversification moves that can pass only one or two tests are suspect.

Approaches to Diversifying the Business Lineup

The means of entering new industries and lines of business can take any of three forms: acquisition, internal start-up, or joint ventures with other companies.

Diversification by Acquisition of an Existing Business

Acquisition is the most popular means of diversifying into another industry. Not only is it quicker than trying to launch a brand new operation, but it also

[2] Michael E. Porter, "From Competitive Advantage to Corporate Strategy," *Harvard Business Review* 45, no. 3 (May–June 1987), pp. 46–49.

offers an effective way to hurdle such entry barriers as acquiring technological know-how, establishing supplier relationships, achieving scale economies, building brand awareness, and securing adequate distribution. Buying an ongoing operation allows the acquirer to move directly to the task of building a strong market position in the target industry, rather than getting bogged down in the fine points of launching a start-up.

The big dilemma an acquisition-minded firm faces is whether to pay a premium price for a successful company or to buy a struggling company at a bargain price.[3] If the buying firm has little knowledge of the industry but has ample capital, it is often better off purchasing a capable, strongly positioned firm—unless the price of such an acquisition is prohibitive and flunks the cost-of-entry test. However, when the acquirer sees promising ways to transform a weak firm into a strong one, a struggling company can be the better long-term investment.

Entering a New Line of Business through Internal Start-Up

Achieving diversification through *internal start-up* involves building a new business subsidiary from scratch. Generally, forming a start-up subsidiary to enter a new business has appeal only when (1) the parent company already has in-house most or all of the skills and resources needed to compete effectively; (2) there is ample time to launch the business; (3) internal entry has lower costs than entry via acquisition; (4) the targeted industry is populated with many relatively small firms such that the new start-up does not have to compete against large, powerful rivals; (5) adding new production capacity will not adversely impact the supply–demand balance in the industry; and (6) incumbent firms are likely to be slow or ineffective in responding to a new entrant's efforts to crack the market.[4]

Using Joint Ventures to Achieve Diversification

A joint venture to enter a new business can be useful in at least two types of situations.[5] First, a joint venture is a good vehicle for pursuing an opportunity that is too complex, uneconomical, or risky for one company to pursue alone. Second, joint ventures make sense when the opportunities in a new industry require a broader range of competencies and know-how than an expansion-minded company can marshal. Many of the opportunities in biotechnology call for the coordinated development of complementary innovations and tackling an intricate web of technical, political, and regulatory factors simultaneously. In such cases, pooling the resources and competencies of two or more companies is a wiser and less risky way to proceed.

However, as discussed in Chapters 6 and 7, partnering with another company—either in the form of a joint venture or collaborative alliance—has significant drawbacks due to the potential for conflicting objectives, disagreements over how to best operate the venture, culture clashes, and so on. Joint

[3] Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980), pp. 354–355.

[4] Ibid., pp. 344–345.

[5] Yves L. Doz and Gary Hamel, *Alliance Advantage: The Art of Creating Value through Partnering* (Boston: Harvard Business School Press, 1998), Chapters 1 and 2.

ventures are generally the least durable of the entry options, usually lasting only until the partners decide to go their own ways.

Defining the Corporate Strategy: Diversification into Related or Unrelated Businesses?

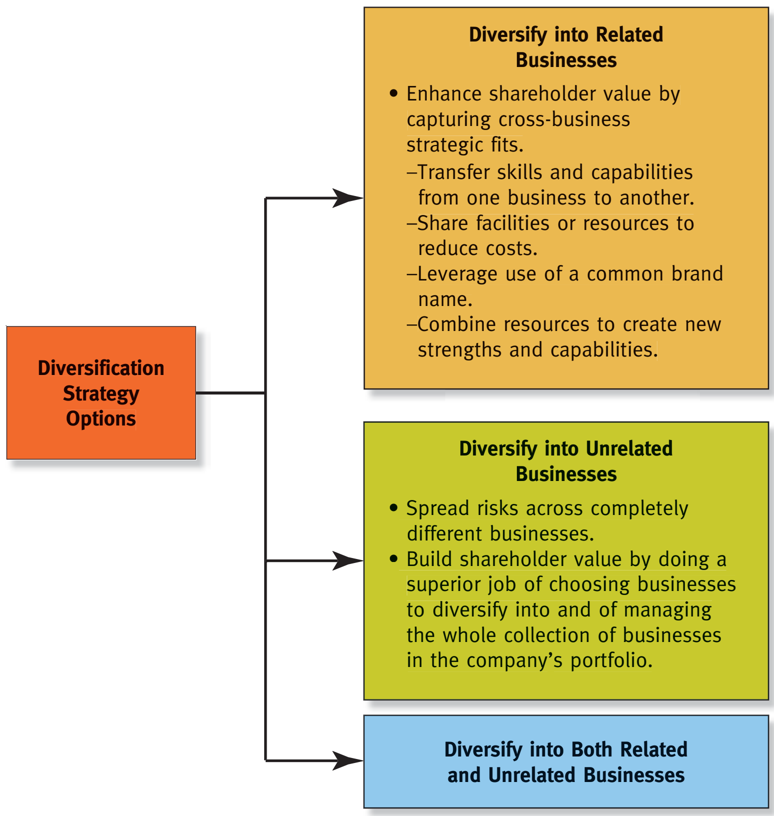
Once a company decides to diversify, its first big corporate strategy decision is whether to diversify into **related businesses, unrelated businesses,** or some mix of both (see Figure 8.1). *Businesses are said to be related when their value chains possess competitively valuable cross-business relationships.* These value chain matchups present opportunities for the businesses to perform better under the same corporate umbrella than they could by operating as standalone entities. *Businesses are said to be unrelated when the activities comprising their respective value chains are so dissimilar that no competitively valuable cross-business relationships are present.*

The next two sections explore the ins and outs of related and unrelated diversification.

The Appeal of Related Diversification

A related diversification strategy involves building the company around businesses whose value chains possess competitively valuable strategic fits,

FIGURE 8.1 **Strategic Themes of Multibusiness Corporations**



as shown in Figure 8.2. **Strategic fit** exists whenever one or more activities comprising the value chains of different businesses are sufficiently similar to present opportunities for:[6]

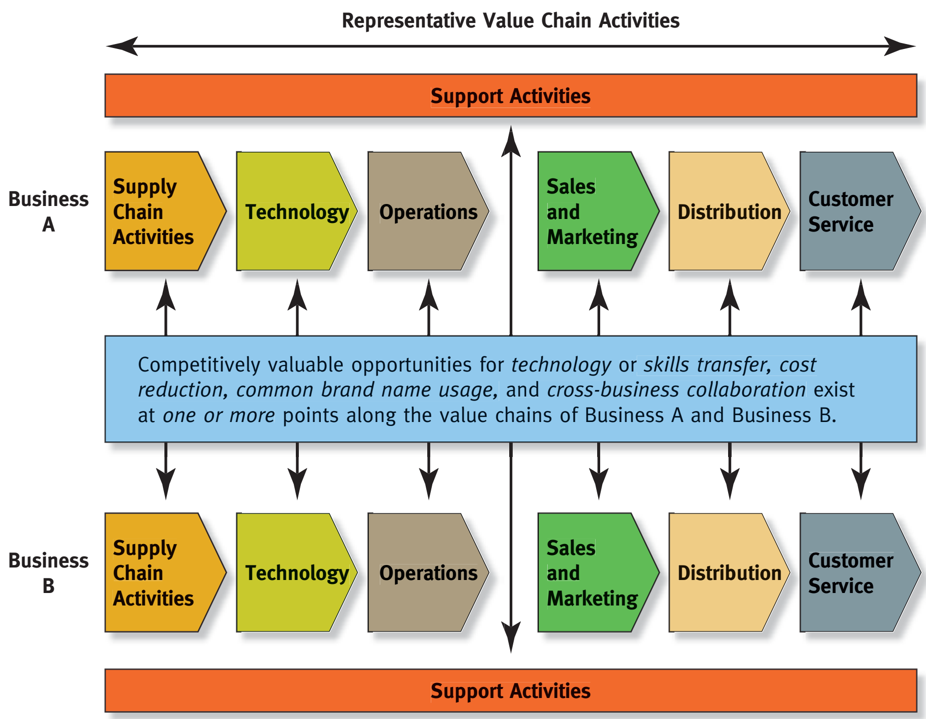
- ***Skills transfer*** involving competitively valuable expertise, technological know-how, or other capabilities from one business to another. Google's technological know-how and innovation capabilities refined in its Internet search business have aided considerably in the development of its Android mobile operating system and Chrome operating system for PCs.

Strategic fit exists when the value chains of different businesses present opportunities for cross-business skills transfer, cost sharing, or brand sharing.

- ***Cost sharing*** between separate businesses where value chain activities can be combined. For example, when Conair Corporation acquired Allegro Manufacturing's travel bag and accessory business in 2007, it was able to consolidate its own distribution centers for hair dryers and curling irons with those of Allegro, thereby generating cost savings for both businesses.
- ***Brand sharing*** between business units that have common customers or that draw upon common core competencies. For example, Yamaha's name

[6] Michael E. Porter, *Competitive Advantage* (New York: Free Press, 1985), pp. 318–319 and pp. 337–353; and Porter, "From Competitive Advantage to Corporate Strategy," pp. 53–57. For an empirical study confirming that strategic fits are capable of enhancing performance (provided the resulting resource strengths are competitively valuable and difficult to duplicate by rivals), see Constantinos C. Markides and Peter J. Williamson, "Corporate Diversification and Organization Structure: A Resource-Based View," *Academy of Management Journal* 39, no. 2 (April 1996), pp. 340–367.

FIGURE 8.2 **Related Diversification Is Built upon Competitively Valuable Strategic Fits in Value Chain Activities**



in motorcycles gave it instant credibility and recognition in entering the personal watercraft business, allowing it to achieve a significant market share without spending large sums on advertising to establish a brand identity for the WaveRunner. Apple's reputation for producting easy-to-operate computers was a competitive asset that facilitated the company's diversification into digital music players.

Cross-business strategic fits can exist anywhere along the value chain—in R&D and technology activities, in supply chain activities, in manufacturing, in sales and marketing, or in distribution activities. Likewise, different businesses can often use the same administrative and customer service infrastructure. For instance, a cable operator that diversifies as a broadband provider can use the same customer data network, the same customer call centers and local offices, the same billing and customer accounting systems, and the same customer service infrastructure to support all of its products and services.[7]

STRATEGIC FIT AND ECONOMIES OF SCOPE Strategic fit in the value chain activities of a diversified corporation's different businesses opens up opportunities for economies of scope—a concept distinct from *economies of scale.* Economies of *scale* are cost savings that accrue directly from a larger-sized operation; for example, unit costs may be lower in a large plant than in a small plant. Economies of *scope,* however, stem directly from cost-saving strategic fits along the value chains of related businesses. Such economies are open only to a multibusiness enterprise and are the result of a related diversification strategy that allows sibling businesses to share technology, perform R&D together, use common manufacturing or distribution facilities, share a common salesforce or distributor/dealer network, and/or share the same administrative infrastructure. *The greater the cross-business economies associated with cost-saving strategic fits, the greater the potential for a related diversification strategy to yield a competitive advantage based on lower costs than rivals.*

THE ABILITY OF RELATED DIVERSIFICATION TO DELIVER COMPETITIVE ADVANTAGE AND GAINS IN SHAREHOLDER VALUE Economies of scope and the other strategic-fit benefits provide a dependable basis for earning higher profits and returns than what a diversified company's businesses could earn as standalone enterprises. Converting the competitive advantage potential into greater profitability is what fuels 1 + 1 = 3 gains in shareholder value—the necessary outcome for satisfying the *better-off test.* There are three things to bear in mind here: (1) Capturing cross-business strategic fits via related diversification builds shareholder value in ways that shareholders cannot replicate by simply owning a

[7] For a discussion of the strategic significance of cross-business coordination of value chain activities and insight into how the process works, see Jeanne M. Liedtka, "Collaboration across Lines of Business for Competitive Advantage," *Academy of Management Executive* 10, no. 2 (May 1996), pp. 20–34.

diversified portfolio of stocks; (2) the capture of cross-business strategic-fit benefits is possible only through related diversification; and (3) the benefits of cross-business strategic fits are not automatically realized—*the benefits materialize only after management has successfully pursued internal actions to capture them.*[8]

Diversifying into Unrelated Businesses

An unrelated diversification strategy discounts the importance of the *better-off test* and, instead, is focused on entering *attractive* industries where the *cost of entry* allows for acceptable returns on investment. *The basic premise of unrelated diversification is that any company or business that can be acquired on good financial terms and that has satisfactory growth and earnings potential represents a good business opportunity.* A corporate strategy based upon unrelated diversification makes no deliberate effort to capture strategic-fit opportunities between the value chains of the firm's various businesses.

Thus, with an unrelated diversification strategy, company managers spend much time and effort screening acquisition candidates and evaluating the pros and cons of keeping or divesting existing businesses, using such criteria as:

- Whether the business can meet corporate targets for profitability and return on investment.
- Whether the business is in an industry with attractive growth potential.
- Whether the business is big enough to contribute *significantly* to the parent firm's bottom line.
- Whether the business has burdensome capital requirements.
- Whether there is industry vulnerability to recession, inflation, high interest rates, tough government regulations concerning product safety or the environment, and other potentially negative factors.

Companies that pursue unrelated diversification nearly always enter new businesses by acquiring an established company rather than by forming a start-up. The premise of acquisition-minded corporations is that growth by acquisition can deliver enhanced shareholder value through upward-trending corporate revenues and earnings and a stock price that *on average* rises enough year after year to amply reward and please shareholders. Three types of acquisition candidates are usually of particular interest: (1) businesses that have bright growth prospects but are short on investment capital, (2) undervalued companies that can be acquired at a bargain price, and (3) struggling companies whose operations can be turned around with the aid of the parent company's financial resources and managerial know-how.

[8] For a discussion of what is involved in actually capturing strategic-fit benefits, see Kathleen M. Eisenhardt and D. Charles Galunic, "Coevolving: At Last, a Way to Make Synergies Work," *Harvard Business Review* 78, no. 1 (January–February 2000), pp. 91–101. Adeptness at capturing cross-business strategic fit positively impacts performance; see Constantinos C. Markides and Peter J. Williamson, "Related Diversification, Core Competencies and Corporate Performance," *Strategic Management Journal* 15 (Summer 1994), pp. 149–165.

UNRELATED DIVERSIFICATION, REVENUE AND EARNINGS GROWTH, AND RISK REDUCTION A strategy of unrelated diversification is suggested to offer growth and reduced risk because of the following factors:

1. Business risk is scattered over a set of truly *diverse* industries. In comparison to related diversification, unrelated diversification more closely approximates *pure* diversification of financial and business risk because the company's investments are spread over businesses whose technologies and value chain activities bear no close relationship and whose markets are largely disconnected.[9]
2. The company's financial resources can be employed to maximum advantage by investing in *whatever industries* offer the best profit prospects (as opposed to considering only opportunities in industries with related value chain activities).
3. To the extent that corporate managers are exceptionally astute at spotting bargain-priced companies with big upside profit potential, shareholder wealth can be enhanced by buying distressed businesses at a low price, turning their operations around fairly quickly, and then enjoying a high return on investment on the newly acquired businesses.
4. Company profitability may prove somewhat less volatile over the course of economic upswings and downswings because market conditions in all industries don't move upward or downward simultaneously. In a broadly diversified company, there's a chance that market downtrends in some of the company's businesses will be partially offset by cyclical upswings in its other businesses. (In actual practice, however, there's no convincing evidence that the consolidated profits of firms with unrelated diversification strategies are more stable in periods of recession and economic stress than the profits of firms with related diversification strategies.)

Unrelated diversification certainly merits consideration when a firm is trapped in or overly dependent on an endangered or unattractive industry. Diversification into industries with closely related value chains might compound the effect of looming industry downturns on shareholder value.

BUILDING SHAREHOLDER VALUE THROUGH UNRELATED DIVERSIFICATION Given the absence of cross-business strategic fits with which to capture added competitive advantage, the task of building shareholder value via unrelated diversification ultimately hinges on the business acumen of corporate executives. To succeed with a corporate strategy keyed to unrelated diversification, corporate executives must:

- Do a superior job of identifying and acquiring new businesses that can produce consistently good earnings and returns on investment (thereby satisfying the attractiveness test).

[9] While the argument that unrelated diversification is a superior way to diversify financial risk has logical appeal, research shows that related diversification is less risky from a financial perspective than is unrelated diversification; see Michael Lubatkin and Sayan Chatterjee, "Extending Modern Portfolio Theory into the Domain of Corporate Diversification: Does It Apply?" *Academy of Management Journal* 37, no. 1 (February 1994), pp. 109–136.

- Do an excellent job of negotiating favorable acquisition prices (thereby satisfying the cost-of-entry test).
- Be shrewd in identifying when to shift resources out of businesses with dim profit prospects and into businesses with above-average prospects for growth and profitability.
- Be good at discerning when a business needs to be sold (because it is on the verge of confronting adverse industry and competitive conditions and probable declines in long-term profitability) and also finding buyers who will pay a price higher than the company's net investment in the business.

A case can be made that shareholder value has truly been enhanced if corporate executives are able to craft and execute a strategy of unrelated diversification that produces enough of the above outcomes to result in a greater than 1 + 1 =2o utcome.

THE PITFALLS OF UNRELATED DIVERSIFICATION Unrelated diversification strategies have two important negatives that undercut the pluses: very demanding managerial requirements and limited competitive advantage potential.

Demanding Managerial Requirements Successfully managing a set of fundamentally different businesses operating in fundamentally different industry and competitive environments is an exceptionally difficult proposition for corporate-level managers. The greater the number of businesses a company is in and the more diverse they are, the more difficult it is for corporate managers to:

1. Stay abreast of what's happening in each industry and each subsidiary.
2. Pick business-unit heads having the requisite combination of managerial skills and know-how to drive gains in performance.
3. Be able to tell the difference between those strategic proposals of business-unit managers that are prudent and those that are risky or unlikely to succeed.
4. Know what to do if a business unit stumbles and its results suddenly headdo wnhill.[10]

In a broadly diversified company like General Electric, corporate executives are challenged to stay abreast of industry developments and the strategic progress of each subsidiary, often depending on financial reports and briefings by business-level managers for many of the details. As a rule, the more unrelated businesses that a company has diversified into, the more corporate executives are forced to "manage by the numbers"—that is, keep a close track on the financial and operating results of each subsidiary and assume that the heads of the various subsidiaries have most everything under control so long as the latest key financial and operating measures look

[10] For a review of the experiences of companies that have pursued unrelated diversification successfully, see Patricia L. Anslinger and Thomas E. Copeland, "Growth through Acquisitions: A Fresh Look," *Harvard Business Review* 74, no. 1 (January–February 1996), pp. 126–135.

good. Managing by the numbers works okay if the heads of the various business units are quite capable and consistently meet their numbers. But the problem comes when things start to go awry and corporate management has to get deeply involved in turning around a business it does not know much about. As the former chairman of a Fortune 500 company advised, "Never acquire a business you don't know how to run."

Unrelated diversification requires that corporate executives rely on the skills and expertise of business-level managers to build competitive advantage and boost the performance of individual businesses.

Competently overseeing a set of widely diverse businesses can turn out to be much harder than it sounds. In practice, comparatively few companies have proved that they have top management capabilities that are up to the task. There are far more companies whose corporate executives have failed at delivering consistently good financial results with an unrelated diversification strategy than there are companies with corporate executives who have been successful.[11] The odds are that the result of unrelated diversification will be 1 + 1 = 2 or less.

Limited Competitive Advantage Potential The second big negative associated with unrelated diversification is that such a strategy *offers no potential for competitive advantage beyond what each individual business can generate on its own.* Unlike a related diversification strategy, there are no cross-business strategic fits to draw on for reducing costs, transferring skills and technology, or leveraging use of a powerful brand name and thereby adding to the competitive advantage possessed by individual businesses. *Without the competitive advantage potential of strategic fits, consolidated performance of an unrelated group of businesses is no better than the sum of what the individual business units could achieve independently.*

Corporate Strategies Combining Related and Unrelated Diversification

There's nothing to preclude a company from diversifying into both related and unrelated businesses. Indeed, the business makeup of diversified companies varies considerably. Some diversified companies are really *dominant-business enterprises*—one major "core" business accounts for 50 to 80 percent of total revenues and a collection of small related or unrelated businesses accounts for the remainder. Some diversified companies are *narrowly diversified* around a few (two to five) related or unrelated businesses. Others are *broadly diversified* around a wide-ranging collection of related businesses, unrelated businesses, or a mixture of both. And a number of multibusiness enterprises have diversified into *several unrelated groups of related businesses.* There's ample room for companies to customize their diversification strategies to incorporate elements of both related and unrelated diversification.

[11] For research evidence of broad diversification failure and the trend of companies to focus their diversification efforts more narrowly, see Lawrence G. Franko, "The Death of Diversification? The Focusing of the World's Industrial Firms, 1980–2000," *Business Horizons* 47, no. 4 (July–August 2004), pp. 41–50.

Evaluating the Corporate Strategy of a Diversified Company

Strategic analysis of diversified companies builds on the methodology used for single-business companies but utilizes tools that streamline the overall process. The procedure for evaluating the pluses and minuses of a diversified company's strategy and deciding what actions to take to improve the company's performance involves six steps:

1. Assessing the attractiveness of the industries the company has diversified into.
2. Assessing the competitive strength of the company's business units.
3. Evaluating the extent of cross-business strategic fits along the value chains of the company's various business units.
4. Checking whether the firm's resources fit the requirements of its present businessl ineup.
5. Ranking the performance prospects of the businesses from best to worst and determining a priority for allocating resources.
6. Crafting new strategic moves to improve overall corporate performance.

The core concepts and analytical techniques underlying each of these steps are discussed further in this section of the chapter.

Step 1: Evaluating Industry Attractiveness

A principal consideration in evaluating the caliber of a diversified company's strategy is the attractiveness of the industries in which it has business operations. The more attractive the industries (both individually and as a group) a diversified company is in, the better its prospects for good long-term performance. A simple and reliable analytical tool for gauging industry attractiveness involves calculating quantitative industry attractiveness scores based upon the following measures.

- *Market size and projected growth rate*—Big industries are more attractive than small industries, and fast-growing industries tend to be more attractive than slow-growing industries, other things being equal.
- *The intensity of competition*—Industries where competitive pressures are relatively weak are more attractive than industries with strong competitivep ressures.
- *Emerging opportunities and threats*—Industries with promising opportunities and minimal threats on the near horizon are more attractive than industries with modest opportunities and imposing threats.
- *The presence of cross-industry strategic fits*—The more the industry's value chain and resource requirements match up well with the value chain activities of other industries in which the company has operations, the more attractive the industry is to a firm pursuing related diversification. However, cross-industry strategic fits may be of no consequence to a company committed to a strategy of unrelated diversification.

- *Resource requirements*—Industries having resource requirements within the company's reach are more attractive than industries where capital and other resource requirements could strain corporate financial resources and organizational capabilities.
- *Seasonal and cyclical factors*—Industries where buyer demand is relatively steady year-round and not unduly vulnerable to economic ups and downs tend to be more attractive than industries with wide seasonal or cyclical swings in buyer demand.
- *Social, political, regulatory, and environmental factors*—Industries with significant problems in such areas as consumer health, safety, or environmental pollution or that are subject to intense regulation are less attractive than industries where such problems are not burning issues.
- *Industry profitability*—Industries with healthy profit margins are generally more attractive than industries where profits have historically been low or unstable.
- *Industry uncertainty and business risk*—Industries with less uncertainty on the horizon and lower overall business risk are more attractive than industries whose prospects for one reason or another are quite uncertain.

Each attractiveness measure should be assigned a weight reflecting its relative importance in determining an industry's attractiveness—it is weak methodology to assume that the various attractiveness measures are equally important. The intensity of competition in an industry should nearly always carry a high weight (say, 0.20 to 0.30). Strategic-fit considerations should be assigned a high weight in the case of companies with related diversification strategies; but for companies with an unrelated diversification strategy, strategic fits with other industries may be given a low weight or even dropped from the list of attractiveness measures altogether. Seasonal and cyclical factors generally are assigned a low weight (or maybe even eliminated from the analysis) unless a company has diversified into industries strongly characterized by seasonal demand and/or heavy vulnerability to cyclical upswings and downswings. The importance weights must add up to 1.0.

Next, each industry is rated on each of the chosen industry attractiveness measures, using a rating scale of 1 to 10 (where 10 signifies *high* attractiveness and 1 signifies *low* attractiveness). Weighted attractiveness scores are then calculated by multiplying the industry's rating on each measure by the corresponding weight. For example, a rating of 8 times a weight of 0.25 gives a weighted attractiveness score of 2.00. The sum of the weighted scores for all the attractiveness measures provides an overall industry attractiveness score. This procedure is illustrated in Table 8.1.

CALCULATING INDUSTRY ATTRACTIVENESS SCORES There are two necessary conditions for producing valid industry attractiveness scores using this method. One is deciding on appropriate weights for the industry attractiveness measures. This is not always an easy task because different analysts have different views about which weights are most appropriate. Also, different weightings may be appropriate for different companies—based on their strategies, performance targets, and financial circumstances. For instance,

Table8.1

Calculating Weighted Industry Attractiveness Scores

INDUSTRY ATTRACTIVENESS MEASURE	IMPORTANCE WEIGHT	INDUSTRY A RATING/ SCORE	INDUSTRY B RATING/ SCORE	INDUSTRY C RATING/ SCORE	INDUSTRY D RATING/ SCORE
Market size and projected growth rate	0.10	8/0.80	5/0.50	2/0.20	3/0.30
Intensity of competition	0.25	8/2.00	7/1.75	3/0.75	2/0.50
Emerging opportunities and threats	0.10	2/0.20	9/0.90	4/0.40	5/0.50
Cross-industry strategic fits	0.20	8/1.60	4/0.80	8/1.60	2/0.40
Resource requirements	0.10	9/0.90	7/0.70	5/0.50	5/0.50
Seasonal and cyclical influences	0.05	9/0.45	8/0.40	10/0.50	5/0.25
Societal, political, regulatory, and environmental factors	0.05	10/0.50	7/0.35	7/0.35	3/0.15
Industry profitability	0.10	5/0.50	10/1.00	3/0.30	3/0.30
Industry uncertainty and business risk	0.05	5/0.25	7/0.35	10/0.50	1/0.05
Sum of the assigned weights	1.00				
Overall weighted industry attractiveness scores		**7.20**	**6.75**	**5.10**	**2.95**

[Rating scale: 1 = Very unattractive to company; 10 = Very attractive to company]

placing a low weight on industry resource requirements may be justifiable for a cash-rich company, whereas a high weight may be more appropriate for a financially strapped company.

The second requirement for creating accurate attractiveness scores is to have sufficient knowledge to rate the industry on each attractiveness measure. It's usually rather easy to locate statistical data needed to compare industries on market size, growth rate, seasonal and cyclical influences, and industry profitability. Cross-industry fits and resource requirements are also fairly easy to judge. But the attractiveness measure that is toughest to rate is that of intensity of competition. It is not always easy to conclude whether competition in one industry is stronger or weaker than in another industry. In the event that the available information is too skimpy to confidently assign a rating value to an industry on a particular attractiveness measure, then it is usually best to use a score of 5, which avoids biasing the overall attractiveness score either up or down.

Despite the hurdles, calculating industry attractiveness scores is a systematic and reasonably reliable method for ranking a diversified company's industries from most to least attractive.

Step 2: Evaluating Business-Unit Competitive Strength

The second step in evaluating a diversified company is to determine how strongly positioned each of its business units are in their respective industries. Doing an appraisal of each business unit's strength and competitive position in its industry not only reveals its chances for industry success but also provides a basis for ranking the units from competitively strongest to weakest. Quantitative measures of each business unit's competitive strength can be calculated using a procedure similar to that for measuring industry attractiveness. The following factors may be used in quantifying the competitive strengths of a diversified company's business subsidiaries:

- *Relative market share*—A business unit's *relative market share* is defined as the ratio of its market share to the market share held by the largest rival firm in the industry, with market share measured in unit volume, not dollars. For instance, if business A has a market-leading share of 40 percent and its largest rival has 30 percent, A's relative market share is 1.33. If business B has a 15 percent market share and B's largest rival has 30 percent, B's relative market share is 0.5.
- *Costs relative to competitors' costs*—There's reason to expect that business units with higher relative market shares have lower unit costs than competitors with lower relative market shares because of the possibility of scale economies and experience or learning-curve effects. Another indicator of low cost can be a business unit's supply chain management capabilities.
- *Products or services that satisfy buyer expectations*—A company's competitiveness depends in part on being able to offer buyers appealing features, performance, reliability, and service attributes.
- *Ability to benefit from strategic fits with sibling businesses*—Strategic fits with other businesses within the company enhance a business unit's competitive strength and may provide a competitive edge.
- *Number and caliber of strategic alliances and collaborative partnerships*—Well-functioning alliances and partnerships may be a source of potential competitive advantage and thus add to a business's competitive strength.
- *Brand image and reputation*—A strong brand name is a valuable competitive asset in most industries.
- *Competitively valuable capabilities*—All industries contain a variety of important competitive capabilities related to product innovation, production capabilities, distribution capabilities, or marketing prowess.
- *Profitability relative to competitors*—Above-average returns on investment and large profit margins relative to rivals are usually accurate indicators of competitive advantage.

After settling on a set of competitive strength measures that are well matched to the circumstances of the various business units, weights indicating each measure's importance need to be assigned. As in the assignment of weights to industry attractiveness measures, the importance weights must add up to 1.0. Each business unit is then rated on each of the chosen strength measures, using a rating scale of 1 to 10 (where 10 signifies competitive *strength* and a 1 rating signifies competitive *weakness*). In the event that the available information is too skimpy to confidently assign a rating value to a business unit on a particular strength measure, then it is usually best to use a score of 5. Weighted strength ratings are calculated by multiplying the business unit's rating on each strength measure by the assigned weight. For example, a strength score of 6 times a weight of 0.15 gives a weighted strength rating of 0.90. The sum

Table8.2

Calculating Weighted Competitive Strength Scores for a Diversified Company's Business Units

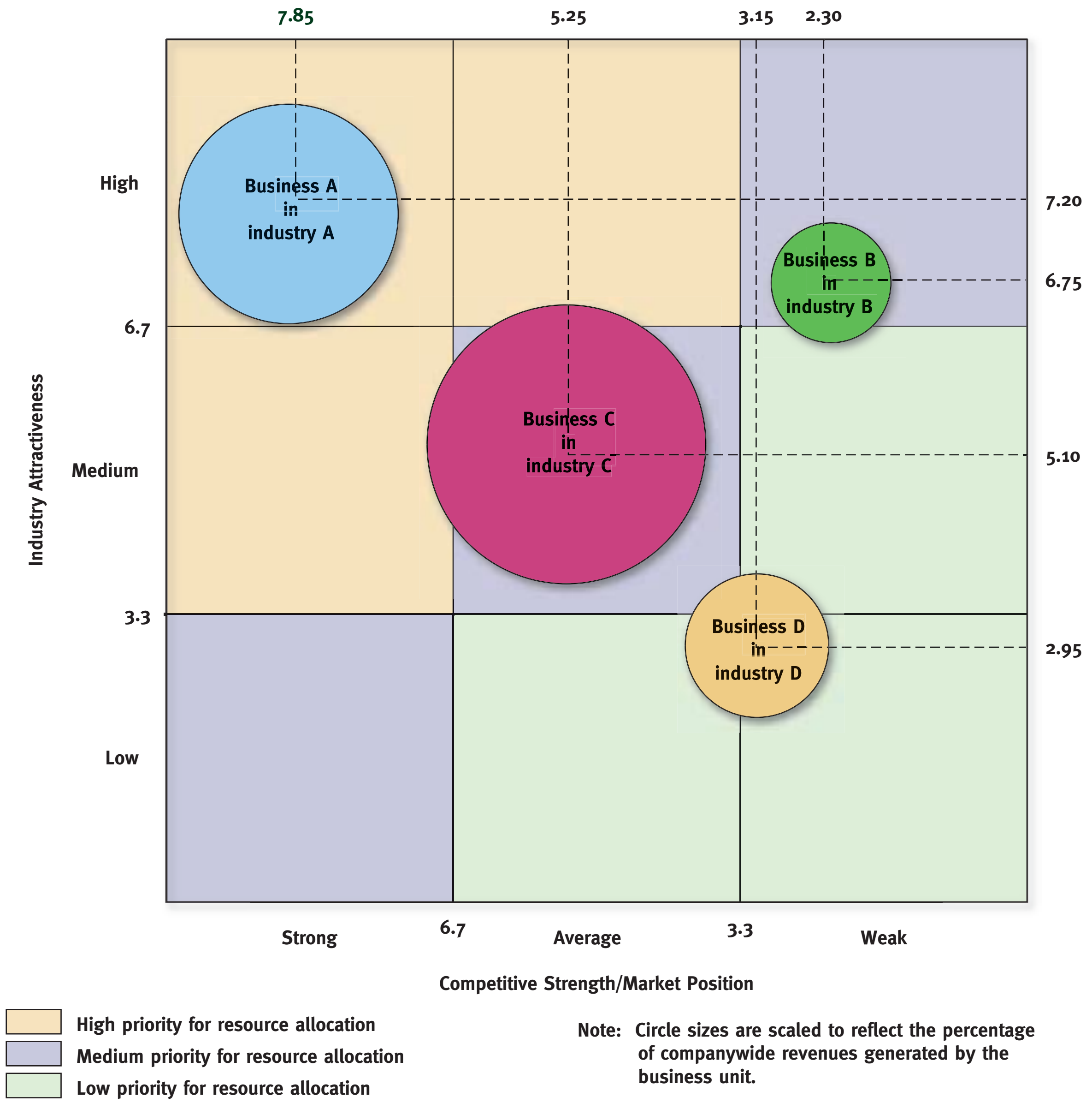
COMPETITIVE STRENGTH MEASURE	IMPORTANCE WEIGHT	BUSINESS A IN INDUSTRY A RATING/SCORE	BUSINESS B IN INDUSTRY B RATING/SCORE	BUSINESS C IN INDUSTRY C RATING/SCORE	BUSINESS D IN INDUSTRY D RATING/SCORE
Relative market share	0.15	10/1.50	1/0.15	6/0.90	2/0.30
Costs relative to competitors' costs	0.20	7/1.40	2/0.40	5/1.00	3/0.60
Ability to match or beat rivals on key product attributes	0.05	9/0.45	4/0.20	8/0.40	4/0.20
Ability to benefit from strategic fits with sister businesses	0.20	8/1.60	4/0.80	4/0.80	2/0.60
Bargaining leverage with suppliers/buyers; caliber of alliances	0.05	9/0.45	3/0.15	6/0.30	2/0.10
Brand image and reputation	0.10	9/0.90	2/0.20	7/0.70	5/0.50
Competitively valuable capabilities	0.15	7/1.05	2/0.30	5/0.75	3/0.45
Profitability relative to competitors	0.10	5/0.50	1/0.10	4/0.40	4/0.40
Sum of the assigned weights	1.00				
Overall weighted competitive strength scores		**7.85**	**2.30**	**5.25**	**3.15**

[Rating scale: 1 = Very weak; 10 = Very strong]

of weighted ratings across all the strength measures provides a quantitative measure of a business unit's overall market strength and competitive standing. Table 8.2 provides sample calculations of competitive strength ratings for four businesses.

USING A NINE-CELL MATRIX TO EVALUATE THE STRENGTH OF A DIVERSIFIED COMPANY'S BUSINESS LINEUP The industry attractiveness and business strength scores can be used to portray the strategic positions of each business in a diversified company. Industry attractiveness is plotted on the vertical axis, and competitive strength on the horizontal axis. A nine-cell grid emerges from dividing the vertical axis into three regions (high, medium, and low attractiveness) and the horizontal axis into three regions (strong, average, and weak competitive strength). As shown in Figure8.3 , high attractiveness is associated with scores of 6.7 or greater on a rating scale of 1 to 10, medium attractiveness to scores of 3.3 to 6.7, and low attractiveness to scores below 3.3. Likewise, high competitive strength is defined as a score

FIGURE 8.3 **A Nine-Cell Industry Attractiveness–Competitive Strength Matrix**



greater than 6.7, average strength as scores of 3.3 to 6.7, and low strength as scores below 3.3. *Each business unit is plotted on the nine-cell matrix according to its overall attractiveness and strength scores, and then shown as a "bubble."* The size of each bubble is scaled to what percentage of revenues the business generates relative to total corporate revenues. The bubbles in Figure 8.3 were located on the grid using the four industry attractiveness scores from Table 8.1 and the strength scores for the four business units in Table 8.2.

The locations of the business units on the attractiveness–strength matrix provide valuable guidance in deploying corporate resources. In general, *a diversified company's best prospects for good overall performance involve concentrating corporate resources on business units having the greatest competitive strength* *and industry attractiveness.* Businesses plotted in the three cells in the upper left portion of the attractiveness–strength matrix have both favorable industry attractiveness and competitive strength and should receive a high investment priority. Business units plotted in these three cells (such as business A in Figure 8.3) are referred to as "grow and build" businesses because of their capability to drive future increases in shareholder value.

Next in priority come businesses positioned in the three diagonal cells stretching from the lower left to the upper right (businesses B and C in Figure 8.3). Such businesses usually merit medium or intermediate priority in the parent's resource allocation ranking. However, some businesses in the medium-priority diagonal cells may have brighter or dimmer prospects than others. For example, a small business in the upper right cell of the matrix (like business B), despite being in a highly attractive industry, may occupy too weak a competitive position in its industry to justify the investment and resources needed to turn it into a strong market contender. If, however, a business in the upper right cell has attractive opportunities for rapid growth and a good potential for winning a much stronger market position over time, management may designate it as a grow-and-build business—the strategic objective here would be to move the business leftward in the attractiveness–strength matrix over time.

Businesses in the three cells in the lower right corner of the matrix (like business D in Figure 8.3) typically are weak performers and have the lowest claim on corporate resources. Such businesses are typically good candidates for being divested or else managed in a manner calculated to squeeze out the maximum cash flows from operations. The cash flows from low-performing/low-potential businesses can then be diverted to financing expansion of business units with greater market opportunities. In exceptional cases where a business located in the three lower right cells is nonetheless fairly profitable or has the potential for good earnings and return on investment, the business merits retention and the allocation of sufficient resources to achieve better performance.

The nine-cell attractiveness–strength matrix provides clear, strong logic for why a diversified company needs to consider both industry attractiveness and business strength in allocating resources and investment capital to its different businesses. A good case can be made for concentrating resources in those businesses that enjoy higher degrees of attractiveness and competitive strength, being very selective in making investments in businesses with intermediate positions on the grid, and withdrawing resources from businesses that are lower in attractiveness and strength unless they offer exceptional profit or cash flow potential.

Step 3: Determining the Competitive Value of Strategic Fits in Multibusiness Companies

The potential for competitively important strategic fits is central to making conclusions about the effectiveness of a company's related diversification strategy. This step can be bypassed for diversified companies whose businesses are all unrelated (because, by design, no strategic fits are present). Checking the competitive

> The greater the value of cross-business strategic fits in enhancing a company's performance in the marketplace or the bottom line, the more powerful is its strategy of related diversification.

advantage potential of cross-business strategic fits involves evaluating how much benefit a diversified company can gain from value chain matchups that present:

1. Opportunities to combine the performance of certain activities, thereby reducing costs and capturing economies of scope.
2. Opportunities to transfer skills, technology, or intellectual capital from one business to another.
3. Opportunities to share use of a well-respected brand name across multiple productan d/ors ervicec ategories.

But more than just strategic fit identification is needed. The real test is what competitive value can be generated from these fits. To what extent can cost savings be realized? How much competitive value will come from cross-business transfer of skills, technology, or intellectual capital? Will transferring a potent brand name to the products of sibling businesses grow sales significantly? Absent significant strategic fits and dedicated company efforts to capture the benefits, one has to be skeptical about the potential for a diversified company's businesses to perform better together than apart.

Step 4: Evaluating the Sufficiency of Corporate Resources in Diversified Companies

The businesses in a diversified company's lineup need to exhibit good resource fit. Resource fit exists when (1) businesses, individually, add to a company's collective resource strengths and (2) a company has sufficient resources to support its entire group of businesses without spreading itself too thin. One important dimension of resource fit concerns whether a diversified company can generate the internal cash flows sufficient to fund the capital requirements of its businesses, pay its dividends, meet its debt obligations, and otherwise remain financially healthy.

FINANCIAL RESOURCE FITS: CASH COWS VERSUS CASH HOGS Different businesses have different cash flow and investment characteristics. For example, business units in rapidly growing industries are often **cash hogs**—so labeled because the cash flows they are able to generate from internal operations aren't big enough to fund their expansion. To keep pace with rising buyer demand, rapid-growth businesses frequently need sizable annual capital infusions—for new facilities and equipment, for technology improvements, and for additional working capital to support inventory expansion. Because a cash hog's financial resources must be provided by the corporate parent, corporate managers have to decide whether it makes good financial and strategic sense to keep pouring new money into a cash hog business.

A **cash hog** generates operating cash flows that are too small to fully fund its operations and growth; a cash hog must receive cash infusions from outside sources to cover its working capital and investment requirements.

In contrast, business units with leading market positions in mature industries may be **cash cows**—businesses that generate substantial cash surpluses over what is needed to adequately fund their operations. Market leaders in slow-growth industries often generate sizable positive cash flows *over and* *above what is needed for growth and reinvestment* because the slow-growth nature of their industry often entails relatively modest annual investment requirements. Cash cows, though not always attractive from a growth standpoint, are valuable businesses from a financial resource perspective. The surplus cash flows they generate can be used to pay corporate dividends, finance acquisitions, and provide funds for investing in the company's promising cash hogs. It makes good financial and strategic sense for diversified companies to keep cash cows in healthy condition, fortifying and defending their market position to preserve their cash-generating capability over the long term and thereby have an ongoing source of financial resources to deploy elsewhere.

A diversified company has good financial resource fit when the excess cash generated by its cash cow businesses is sufficient to fund the investment requirements of promising cash hog businesses. Ideally, investing in promising cash hog businesses over time results in growing the hogs into self-supporting *star businesses* that have strong or market-leading competitive positions in attractive, high-growth markets and high levels of profitability. Star businesses are often the cash cows of the future—when the markets of star businesses begin to mature and their growth slows, their competitive strength should produce self-generated cash flows more than sufficient to cover their investment needs. The "success sequence" is thus cash hog to young star (but perhaps still a cash hog) to self-supporting star to cash cow.

A **cash cow** generates operating cash flows over and above its internal requirements, thereby providing financial resources that may be used to invest in cash hogs, finance new acquisitions, fund share buyback programs, or pay dividends.

If, however, a cash hog has questionable promise (either because of low industry attractiveness or a weak competitive position), then it becomes a logical candidate for divestiture. Aggressively investing in a cash hog with an uncertain future seldom makes sense because it requires the corporate parent to keep pumping more capital into the business with only a dim hope of turning the cash hog into a future star. Such businesses are a financial drain and fail the resource fit test because they strain the corporate parent's ability to adequately fund its other businesses. Divesting a less attractive cash hog business is usually the best alternative unless (1) it has highly valuable strategic fits with other business units or (2) the capital infusions needed from the corporate parent are modest relative to the funds available, and (3) there's a decent chance of growing the business into a solid bottom-line contributor.

Aside from cash flow considerations, there are two other factors to consider in assessing the financial resource fit for businesses in a diversified firm's portfolio:

- *Do individual businesses adequately contribute to achieving companywide performance targets?* A business exhibits poor financial fit if it soaks up a disproportionate share of the company's financial resources, while making subpar or insignificant contributions to the bottom line. Too many underperforming businesses reduce the company's overall performance and ultimately limit growth in shareholder value.
- *Does the corporation have adequate financial strength to fund its different businesses and maintain a healthy credit rating?* A diversified company's strategy fails the resource fit test when the resource needs of its portfolio unduly

stretch the company's financial health and threaten to impair its credit rating. General Motors, Time Warner, and Royal Ahold, for example, found themselves so financially overextended that they had to sell off some of their business units to raise the money to pay down burdensome debt obligations and continue to fund essential capital expenditures for the remaining businesses.

EXAMINING A DIVERSIFIED COMPANY'S NONFINANCIAL RESOURCE FITS Diversified companies must also ensure that the nonfinancial resource needs of its portfolio of businesses are met by its corporate capabilities. Just as a diversified company must avoid allowing an excessive number of cash hungry businesses to jeopardize its financial stability, it should also avoid adding to the business lineup in ways that overly stretch such nonfinancial resources as managerial talent, technology and information systems, and marketing support.

- *Does the company have or can it develop the specific resource strengths and competitive capabilities needed to be successful in each of its businesses?*[12]S ometimes the resource strengths a company has accumulated in its core business prove to be a poor match with the competitive capabilities needed to succeed in businesses into which it has diversified. For instance, LVMH, a multibusiness company in France, discovered that the company's resources and managerial skills were quite well suited for parenting luxury goods businesses including Louis Vuitton, Christian Dior, Givenchy, Fendi, Dom Perignon, Moët & Chandon, and Hennessy but not for parenting art auctioning and radio stations; as a consequence, LVMH decided to divest its art auctioning and radio broadcasting businesses after those businesses had run up significant operating losses and proved to be a drain on the corporate treasury. Thus, a mismatch between the company's resource strengths and the key success factors in a particular business can be serious enough to warrant divesting an existing business or not acquiring a new business. In contrast, when a company's resources and capabilities are a good match with the key success factors of industries it is not presently in, it makes sense to take a hard look at acquiring companies in thesei ndustries.

Resource fit extends beyond financial resources to include a good fit between the company's resource strengths and competencies and the key success factors of each industry it has diversified into.

- *Are recently acquired businesses acting to strengthen a company's resource base and competitive capabilities or are they causing its competitive and managerial resources to be stretched too thin?* A diversified company has to guard against overtaxing its resource strengths, a condition that can arise when (1) it goes on an acquisition spree and management is called upon to assimilate and oversee many new businesses very quickly or (2) when it lacks sufficient resource depth to do a creditable job of transferring skills and competencies from one of its businesses to another.

[12] For an excellent discussion of what to look for in assessing these fits, see Andrew Campbell, Michael Gould, and Marcus Alexander, "Corporate Strategy: The Quest for Parenting Advantage," *Harvard Business Review* 73, no. 2 (March–April 1995), pp. 120–132.

Step 5: Ranking Business Units and Setting a Priority for Resource Allocation

Once a diversified company's strategy has been evaluated from the perspective of industry attractiveness, competitive strength, strategic fit, and resource fit, the next step is to rank the performance prospects of the businesses from best to worst. Once this ranking has been established, management is in a good position to decide which businesses merit top priority for resource support and new capital investments by the corporate parent. The most important consideration in settling on resource allocation decisions is business units' past performance in terms of sales growth, profit growth, contribution to company earnings, cash flow characteristics, and return on capital invested in the business. While past performance is not necessarily a good predictor of future performance, it does signal whether a business already has good to excellent performance or has problems to overcome.

Furthermore, the industry attractiveness/business strength evaluations provide a solid basis for judging a business's future prospects. Normally, strong business units in attractive industries have significantly better prospects of turning in stellar results than weak businesses in unattractive industries. And, normally, the revenue and earnings outlook for businesses in fast-growing industries is better than for businesses in slow-growing industries. One important exception is when a strong business in a slow-growing industry continues to draw sales and market share away from its rivals and thus achieves faster growth than the industry as a whole. As a rule, the prior analyses, taken together, signal which business units are likely to be strong performers on the road ahead and which are likely to be laggards. The task here is to decide which business units should have top priority for corporate resource support and new capital investment and which should carry the lowest priority. *Business units with the brightest profit and growth prospects and solid strategic and resource fits generally should head the list for corporate resource support.*

Step 6: Crafting New Strategic Moves to Improve the Overall Corporate Performance

The conclusions flowing from the five preceding analytical steps set the agenda for crafting strategic moves to improve a diversified company's overall performance. The strategic options boil down to four broad categories of actions:

1. Sticking closely with the existing business lineup and pursuing the opportunities these businesses present.
2. Broadening the company's business scope by making new acquisitions in newi ndustries.
3. Divesting some businesses and retrenching to a narrower base of business operations.
4. Restructuring the company's business lineup and putting a whole new face on the company's business makeup.

STICKING CLOSELY WITH THE EXISTING BUSINESS LINEUP The option of sticking with the current business lineup makes sense when the company's present businesses offer attractive growth opportunities and can be counted on to generate good earnings and cash flows. As long as the company's set of existing businesses puts it in a good position for the future and these businesses have good strategic and/or resource fits, then rocking the boat with major changes in the company's business mix is usually unnecessary. Corporate executives can concentrate their attention on getting the best performance from each of the businesses, steering corporate resources into those areas of greatest potential and profitability. However, in the event that corporate executives are not entirely satisfied with the opportunities they see in the company's present set of businesses, they can opt for any of the three strategic alternatives listed in the following sections.

BROADENING THE DIVERSIFICATION BASE Diversified companies sometimes find it desirable to add to the diversification base for any one of the same reasons a single business company might pursue initial diversification. Sluggish growth in revenues or profits, vulnerability to seasonality or recessionary influences, potential for transferring resources and capabilities to other related businesses, or unfavorable driving forces facing core businesses are all reasons management of a diversified company might choose to broaden diversification. An additional, and often very important, motivating factor for adding new businesses is to complement and strengthen the market position and competitive capabilities of one or more of its present businesses. Procter & Gamble's 2005 acquisition of Gillette strengthened and extended P&G's reach into personal care and household products—Gillette's businesses included Oral-B toothbrushes, Gillette razors and razor blades, Duracell batteries, Braun shavers and small appliances (coffeemakers, mixers, hair dryers, and electric toothbrushes), and toiletries (Right Guard, Foamy, Soft & Dry, White Rain, and Dry Idea).

DIVESTING SOME BUSINESSES AND RETRENCHING TO A NARROWER DIVERSIFICATION BASE A number of diversified firms have had difficulty managing a diverse group of businesses and have elected to get out of some of them. Retrenching to a narrower diversification base is usually undertaken when top management concludes that its diversification strategy has ranged too far afield and that the company can improve long-term performance by concentrating on building stronger positions in a smaller number of core businesses and industries. Hewlett-Packard spun off its testing and measurement businesses into a standalone company called Agilent Technologies so that it could better concentrate on its PC, workstation, server, printer and peripherals, and electronics businesses.

> Focusing corporate resources on a few core and mostly related businesses avoids the mistake of diversifying so broadly that resources and management attention are stretched too thin.

But there are other important reasons for divesting one or more of a company's present businesses. Sometimes divesting a business has to be considered because market conditions in a once-attractive industry have badly deteriorated. A business can become a prime candidate for divestiture because it lacks adequate strategic or resource fit, because it is a cash hog with questionable long-term potential, or because it is weakly positioned in its industry with little prospect of earning a decent return on investment. Sometimes a company acquires businesses that, down the road, just do not work out as expected even though management has tried all it can think of to make them profitable. Other business units, despite adequate financial performance, may not mesh as well with the rest of the firm as was originally thought.

Time Warner's 2000 merger with AOL proved to be a dismal failure—its planned convergence of Time Warner Entertainment's movies, music, magazine content, and cable network programming with AOL's Internet platform and Time Warner Cable's broadband capabilities never materialized, the cultures of the three divisions prevented the capture of strategic fit benefits, and shareholder value eroded by nearly 80 percent. After struggling for more than seven years to make a success of its diversification, Time Warner management spun off its Time Warner Cable operations into an independent business and began evaluating offers from buyers interested in purchasing AOL.

There's evidence indicating that pruning businesses and narrowing a firm's diversification base improves corporate performance.[13] Corporate parents often end up selling off businesses too late and at too low a price, sacrificing shareholder value.[14] A useful guide to determine whether or when to divest a business subsidiary is to ask, "If we were not in this business today, would we want to get into it now?"[15] When the answer is no or probably not, divestiture should be considered. Another signal that a business should become a divestiture candidate is whether it is worth more to another company than to the present parent; in such cases, shareholders would be well served if the company were to sell the business and collect a premium price from the buyer for whom the business is a valuable fit.[16]

Options for Divesting a Business: Sell or Spin Off? Selling a business outright to another company is far and away the most frequently used option for divesting a business. However, finding a buyer can prove difficult or easy, depending on the business. As a rule, a company selling a troubled business should not ask, "How can we pawn this business off on someone, and what is the most we can get for it?"[17] Instead, it is wiser to ask, "For what sort of company would this business be a good fit, and under what conditions would it be viewed as a good deal?"[18] But sometimes a business selected for divestiture

[13] See, for, example, Constantinos C. Markides, "Diversification, Restructuring, and Economic Performance," *Strategic Management Journal* 16 (February 1995), pp. 101–118.

[14] For a discussion of why divestiture needs to be a standard part of any company's diversification strategy, see Lee Dranikoff, Tim Koller, and Antoon Schneider, "Divestiture: Strategy's Missing Link," *Harvard Business Review* 80, no. 5 (May 2002), pp. 74–83.

[15] Peter F. Drucker, *Management: Tasks, Responsibilities, Practices*, (New York: Harper & Row, 1974), p. 94.

[16] See David J. Collis and Cynthia A. Montgomery, "Creating Corporate Advantage," *Harvard Business Review* 76, no. 3 (May–June 1998), pp. 72–80.

[17] Drucker, *Management: Tasks, Responsibilities, Practices*, p. 719.

[18] Approaches to identifying buyers for divestiture candidates and maximizing prices fetched for divested businesses are discussed in Michael C. Mankins, David Harding, and Rolf-Magnus Weddigen, "How the Best Divest," *Harvard Business Review* 86, no. 10 (October 2008), pp. 92–99.

has ample resource strengths to compete successfully on its own. In such cases, a corporate parent may elect to spin the unwanted business off as a financially and managerially independent company, either by selling shares to the investing public via an initial public offering or by distributing shares in the new company to existing shareholders of the corporate parent.

IAC/InterActive, which operated a host of Internet properties such as Ask.com and Match.com, spun off several businesses in 2008 because of lackluster performance and challenging industry conditions. The company's spinoff of its Lending Tree mortgage loan service unit, a timeshare-exchange business, Ticketmaster, and the Home Shopping Network yielded $1.3 billion that management planned to use to support investments in remaining businesses and fund a share buyback plan intended to help boost the company's dramatically declining stock price.

When a corporate parent decides to spin off one of its businesses as a separate company, there's the issue of whether or not to retain partial ownership. Retaining partial ownership makes sense when the business to be divested has a hot product or technological capabilities that give it good profit prospects. When Bank of America elected to divest its CTC Consulting business unit, which made independent investment recommendations to clients with extreme wealth, it elected to retain an ownership interest in the business so as to provide Bank of America shareholders a way of participating in whatever future market success that CTC might have on its own. Bank of America also retained a 6 percent ownership in China Construction Bank after it was forced to divest a much larger interest in China's second largest lender in 2009 to meet capital requirements specified by the U.S. Federal Reserve. Of course, if the business is unable to support itself as an independent company and a buyer willing to pay an acceptable price cannot be found, then a company must decide whether to keep the business until a buyer appears or simply close it down and liquidate the remaining assets. Liquidation is obviously a last resort.

BROADLY RESTRUCTURING THE BUSINESS LINEUP THROUGH A MIX OF DIVESTITURES AND NEW ACQUISITIONS **Restructuring** strategies involve divesting some businesses and acquiring others so as to put a whole new face on the company's business lineup. Performing radical surgery on a company's group of businesses is an appealing corporate strategy when its financial performance is squeezed or eroded by:

- Too many businesses in slow-growth, declining, low-margin, or otherwise unattractivei ndustries.
- Too many competitively weak businesses.
- An excessive debt burden with interest costs that eat deeply into profitability.
- Ill-chosen acquisitions that haven't lived up to expectations.

Restructuring involves radically altering the business lineup by divesting businesses that lack strategic fit or are poor performers and acquiring new businesses that offer better promise for enhancing shareholder value.

Candidates for divestiture in a corporate restructuring effort typically include not only weak or up-and-down performers or those in unattractive industries

Concepts & Connections 8.1

VF'S CORPORATE RESTRUCTURING STRATEGY THAT MADE IT THE STAR OF THE APPAREL INDUSTRY

VF Corporation's corporate restructuring that included a mix of divestitures and acquisitions has provided its shareholders with returns that are more than five times greater than shareholder returns provided by competing apparel manufacturers. In fact, VF delivered a total shareholder return of 80 percent between 1999 and 2009 and its 2008 revenues of $7.6 billion made it number 332 on *Fortune*'s list of the 500 largest U.S. companies. The company's corporate restructuring began in 2000 when it divested its slow-growing businesses including its namesake Vanity Fair brand of lingerie and sleepwear. The company's $136 million acquisition of North Face in 2000 was the first in a series of many acquisitions of "lifestyle brands" that connected with the way people lived, worked, and played. Since the acquisition and turnaround of North Face, VF has spent $2.8 billion to acquire 18 additional businesses. New apparel brands acquired by VF Corporation include Vans skateboard shoes, Nautica, John Varvatos, and 7 For All Mankind sportswear, Reef surf wear, and Lucy athletic wear. The company also acquired a variety of apparel companies specializing in apparel segments such as uniforms for professional baseball and football teams and law enforcement.

VF Corporation's acquisitions came after years of researching each company and developing a relationship with an acquisition candidate's chief managers before closing the deal. The company made a practice of leaving management of acquired companies in place, while bringing in new managers only when necessary talent and skills were lacking. In addition, companies acquired by VF were allowed to keep long-standing traditions that shaped culture and spurred creativity. For example, the Vans headquarters in Cypress, California, retained its halfpipe and concrete floor so that its employees could skateboard to and from meetings.

In 2008, VF Corporation was the most profitable apparel firm in the industry with net earnings of $603 million. The company expected new acquisitions that would push the company's revenues to $11 billion by 2012.

Sources: Suzanne Kapner, "How a 100-Year-Old Apparel Firm Changed Course," *Fortune*, April 9, 2008, online edition; and www.vf.com, accessed July 12, 2009.

but also business units that lack strategic fit with the businesses to be retained, businesses that are cash hogs or that lack other types of resource fit, and businesses incompatible with the company's revised diversification strategy (even though they may be profitable or in an attractive industry). As businesses are divested, corporate restructuring generally involves aligning the remaining business units into groups with the best strategic fits and then redeploying the cash flows from the divested business to either pay down debt or make new acquisitions.[19] In a study of the performance of the 200 largest U.S. corporations from 1990 to 2000, McKinsey & Company found that those companies that actively managed their business portfolios through acquisitions and divestitures created substantially more shareholder value than those that kept a fixed lineup of businesses.[20]

Over the past decade, corporate restructuring has become a popular strategy at many diversified companies, especially those that had diversified broadly into many different industries and lines of business. For instance, between 1994

[19] Evidence that restructuring strategies tend to result in higher levels of performance is contained in Markides, "Diversification, Restructuring and Economic Performance," pp. 101–118.

[20] Dranikoff, Koller, and Schneider, "Divestiture: Strategy's Missing Link," p. 76.

and 2005 Ingersoll Rand radically restructured its business lineup by divesting its automotive components and mining components, business units that accounted for 56 percent of its total revenues. During the same time period, Ingersoll Rand made acquisitions of new businesses that went on to account for 52 percent of its 2005 total revenues. In 2007, the company executed the $6.2 billion sale of its road development, Bobcat, and utility equipment businesses and completed a variety of small acquisitions. Its corporate restructuring continued into 2008, with its $9.5 billion acquisition of Trane, a maker of heating and air conditioning products. Trane had just undergone its own restructuring one year earlier when American Standard divested its legacy plumbing fixture business, spun off an automotive braking unit, and changed its name to Trane to reflect its new focus on heating and air conditioning. Concepts & Connections 8.1 discusses how VF Corporation shareholders have benefited through the company's large-scale restructuring program.

KeyP oints

1. Thep urposeo fd iversification is to build shareholder value. Diversification builds shareholder value when a diversified group of businesses can perform better under the auspices of a single corporate parent than they would as independent, standalone businesses—the goal is to achieve not just a 1 + 1 = 2 result but rather to realize important 1 + 1 = 3 performance benefits. Whether getting into a new business has potential to enhance shareholder value hinges on whether a company's entry into that business can pass the attractiveness test, the cost-of-entry test, and the better-off test.
2. Entry into new businesses can take any of three forms: acquisition, internal start-up, or joint venture/strategic partnership. Each has its pros and cons, but acquisition is the most frequently used; internal start-up takes the longest to produce home-run results, and joint venture/strategic partnership, though used second most frequently, is the least durable.
3. There are two fundamental approaches to diversification—into related businesses and into unrelated businesses. The rationale for *related*d iversification is *strategic:* Diversify into businesses with strategic fits along their respective value chains, capitalize on strategic-fit relationships to gain competitive advantage, and then use competitive advantage to achieve the desired 1 + 1 = 3 impact on shareholderv alue.
4. The basic premise of *unrelated*d iversification is that any business that has good profit prospects and can be acquired on good financial terms is a good business to diversify into. Unrelated diversification strategies surrender the competitive advantage potential of strategic fit in return for such advantages as (1) spreading business risk over a variety of industries and (2) providing opportunities for financial gain (if candidate acquisitions have undervalued assets, are bargain-priced, or need the backing of a financially strong parent to capitalize on attractive opportunities). However, the greater the number of businesses a company

has diversified into and the more diverse these businesses are, the harder it is for corporate executives to select capable managers to run each business, know when the major strategic proposals of business units are sound, or decide on a wise course of recovery when a business unit stumbles.

5. Analyzing how good a company's diversification strategy is a six-step process:

    - Step1: *Evaluate the long-term attractiveness of the industries into which the firm has diversified.* Determining industry attractiveness involves developing a list of industry attractiveness measures, each of which might have a different importancew eight.
    - Step2: *Evaluate the relative competitive strength of each of the company's business units.* The purpose of rating each business's competitive strength is to gain clear understanding of which businesses are strong contenders in their industries, which are weak contenders, and the underlying reasons for their strength or weakness. The conclusions about industry attractiveness can be joined with the conclusions about competitive strength by drawing an industry attractiveness–competitive strength matrix that helps identify the prospects of each business and what priority each business should be given in allocating corporate resources and investment capital.
    - Step3: *Check for cross-business strategic fits.* A business is more attractive strategically when it has value chain relationships with sibling business units that offer the potential to (1) realize economies of scope or cost-saving efficiencies; (2) transfer technology, skills, know-how, or other resource capabilities from one business to another; and/or (3) leverage use of a well-known and trusted brand name. Cross-business strategic fits represent a significant avenue for producing competitive advantage beyond what any one business can achieve on its own.
    - Step4: *Check whether the firm's resource strengths fit the resource requirements of its present business lineup.* Resource fit exists when (1) businesses add to a company's resource strengths, either financially or strategically; and (2) a company has the resources to adequately support the resource requirements of its businesses as a group without spreading itself too thin. One important test of financial resource fit involves determining whether a company has ample cash cows and not too many cash hogs.
    - Step5: *Rank the performance prospects of the businesses from best to worst and determine what the corporate parent's priority should be in allocating resources to its various businesses.* The most important considerations in judging business-unit performance are sales growth, profit growth, contribution to company earnings, cash flow characteristics, and the return on capital invested in the business. Normally, strong business units in attractive industries should head the list for corporate resource support.
    - Step6: *Crafting new strategic moves to improve overall corporate performance.* This step entails using the results of the preceding analysis as the basis for selecting one of four different strategic paths for improving a diversified company's performance: (a) Stick closely with the existing business lineup and pursue opportunities presented by these businesses, (b) broaden the scope of diversification by entering additional industries, (c) retrench to a narrower scope of diversification by divesting poorly performing businesses, and (d) broadly restructure the business lineup with multiple divestitures and/or acquisitions.

Assurance of Learning Exercises

1. See if you can identify the value chain relationships which make the businesses of the following companies related in competitively relevant ways. In particular, you should consider whether there are cross-business opportunities for (1) skills/technology transfer, (2) combining related value chain activities to achieve lower costs, and/or (3) leveraging use of a well-respected brand name. LO2

OutbackSteakhous e

- OutbackS teakhouse
- Carrabba'sI talianG rill
- Roy'sR estaurant(Hawaiianf usionc uisine)
- Bonefish Grill (Market-fresh fine seafood)
- Fleming's Prime Steakhouse & Wine Bar
- Lee Roy Selmon's (Southern comfort food)
- Cheeseburgeri nP aradise
- Blue Coral Seafood & Spirits (Fine seafood)

L'Oréal

- Maybelline, Lancôme, Helena Rubenstein, Kiehl's, Garner, and Shu Uemura cosmetics
- L'Oréal and Soft Sheen/Carson hair care products
- Redken, Matrix, L'Oréal Professional, and Kerastase Paris professional hair care and skin care products
- RalphL aurenan dG iorgio Armanif ragrances
- Biotherms kincarep roducts
- LaRo che–Posayan dV ichyL aboratoriesd ermocosmetics

Johnson&J ohnson

- Baby products (powder, shampoo, oil, lotion)
- Band-Aidsan do therfi rst-aid products
- Women's health and personal care products (Stayfree, Carefree, Sure & Natural)
- Neutrogenaan d Aveenos kinc arep roducts
- Nonprescription drugs (Tylenol, Motrin, Pepcid AC, Mylanta, Monistat)
- Prescriptiond rugs
- Prosthetican do therme dicald evices
- Surgicalan dh ospitalp roducts
- Accuvuec ontactl enses

2. Thede fining characteristic of unrelated diversification is few competitively valuable cross-business relationships. Peruse the business group listings for Lancaster Colony shown on the next page and see if you can confirm why it is pursuing an unrelated diversification strategy. LO3

Lancaster Colony's business lineup

- Specialty food products: Cardini, Marzetti, Girard's, and Pheiffer salad dressings; T. Marzetti and Chatham Village croutons; Jack Daniels mustards; Inn Maid noodles; New York and Mamma Bella garlic breads; Reames egg noodles; Sister Schubert's rolls; and Romanoff caviar
- Candle-lite brand candles marketed to retailers and private-label customers chains
- Glassware, plastic ware, coffee urns, and matting products marketed to the food-service and lodging industry

If need be, visit the company's Web site (www.lancastercolony.com) to obtain additional information about its business lineup and strategy.

LO2 LO3 LO4

3. General Electric recently organized its broadly diversified lineup of products and services into the following business groups:

   - Capital Finance: Commercial and consumer finance (loans, operating leases, financing programs and financial services provided to corporations, retailers, and consumers in 35 countries)—revenues of $67.0 billion in 2008.
   - Technology Infrastructure: Jet engines for military and civil aircraft, freight and passenger locomotives, medical imaging and information technologies, medical diagnostics, patient monitoring systems, disease research, drug discovery and biopharmaceuticals—revenues of $46.3 billion in 2008.
   - Consumer & Industrial: Consumer appliances and electrical equipment; industrial automation hardware and software, controls, sensors, and security systems—revenues of $11.7 billion in 2008.
   - Energy Infrastructure: Gas turbines for marine and industrial applications, electric power generation equipment, power transformers, high-voltage breakers, distribution transformers and breakers, capacitors, relays, regulators, substation equipment, metering products—revenues of $38.6 billion in 2008.
   - NBC Universal: Owns and operates the NBC television network, a Spanish-language network (Telemundo), several news and entertainment networks (CNBC, MSNBC, Bravo, Sci-Fi Channel, Sleuth, USA Network), Universal Pictures, Universal Studios Home Entertainment, various television production operations, several special interest Internet sites, a group of television stations, and theme parks—revenues of $17.0 billion in 2008.

   a. IsG E'sdi versified business lineup best characterized as unrelated diversification or a combination of related and unrelated diversification?
   b. Is GE more accurately categorized as a dominant business enterprise or a broadly diversified conglomerate or something else?
   c. Do you see any strategic fit opportunities in GE's business lineup? Are these strategic fit opportunities, if any, more within each of the five business groupings or do they (also?) cut across the five business groupings? Explain.

Exercisesf or Simulation Participants

1. If your company can diversify into multiple products/businesses, are the diversification opportunities best characterized as related or unrelated? Explain. If the diversification opportunities are related, what precisely are the strategic fit relationships that are available for capture? **LO1 LO2 LO3 LO4**
2. Irrespective of whether your company has the option to diversify into other products/businesses, what specific resources does your company have that would make it attractive to diversify into related businesses? List as many resource strengths as you think are transferable to other businesses and also indicate what kinds of strategic fit benefits could be captured with these resource strengths?
3. Assuming your company has the option to diversify into other products or businesses of your choosing, would you prefer to pursue a strategy of related or unrelated diversification? Why?

Chapter 9

Ethical Business Strategies, Corporate Social Responsibility, and Environmental Sustainability

Chapter Learning Objectives

LO1. Understand why the standards of ethical behavior in business are no different from the ethical standards and norms of the larger society and culture in which a company operates.

LO2. Recognize conditions that give rise to unethical business strategies and behavior.

LO3. Gain an understanding of the costs of business ethics failures.

LO4. Become familiar with how companies that operate in countries with different cultures and ethical norms ensure a consistent commitment to business ethics.

LO5. Gain an understanding of the concepts of corporate social responsibility, corporate citizenship, and corporate sustainability and how companies balance these duties with economic responsibilities to shareholders.

Clearly, a company has a responsibility to make a profit and grow the business, but just as clearly, a company and its personnel also have a duty to obey the law and play by the rules of fair competition. But does a company have a duty to go beyond legal requirements and operate according to the ethical norms of the societies in which it operates? And does it have a duty or obligation to contribute to the betterment of society independent of the needs and preferences of the customers it serves? Should a company display a social conscience and devote a portion of its resources to bettering society? Should its strategic initiatives be screened for possible negative effects on future generations of the world's population?

The focus of this chapter is to examine what link, if any, there should be between a company's efforts to craft and execute a winning strategy and its duties to (1) conduct its activities in an ethical manner, (2) demonstrate socially responsible behavior by being a committed corporate citizen, and (3) limit its strategic initiatives to those that meet the needs of consumers without depleting resources needed by future generations.

Business Ethics and the Tasks of Crafting and Executing Strategy

Business ethics is the application of ethical principles and standards to business behavior.[1] Ethical principles in business are not materially different from ethical principles in general because business actions have to be judged in the context of society's standards of right and wrong. There is not a special set of rules that business people decide to apply to their own conduct. If dishonesty is considered unethical and immoral, then dishonest behavior in business—whether it relates to customers, suppliers, employees, or shareholders—qualifies as equally unethical and immoral. If being ethical entails adhering to generally accepted norms about conduct that is right and wrong, then managers must consider such norms when crafting and executing strategy.

Business ethics involves the application of ethical standards and principles to business activities, behavior, and decisions.

While most company managers are careful to ensure that a company's strategy is within the bounds of what is legal, evidence indicates they are not always so careful to ensure that their strategies are within the bounds of what is considered ethical. In recent years, there has been an ongoing series of revelations where managers at such companies as Enron, Tyco International, HealthSouth, Adelphia, Royal Dutch/Shell, Parmalat (an Italy-based food products company), Rite Aid, Mexican oil giant Pemex, AIG, Citigroup, several leading brokerage houses, mutual fund companies and investment banking firms, and a host of mortgage lenders have deliberately ignored society's ethical norms. Alstom SA, a giant France-based engineering firm and maker of power plant turbines and high-speed trains and subway cars, has been accused by French and Swiss prosecutors of using a Swiss slush fund to pay $500 million in bribes to foreign officials to win contracts abroad during 2001–2008; executives at

[1] James E. Post, Anne T. Lawrence, and James Weber, *Business and Society: Corporate Strategy, Public Policy, Ethics*, 10th ed. (Burr Ridge, IL: McGraw-Hill Irwin, 2002), p. 103.

Siemens AG of Germany, one of Alstom's competitors, have been charged by German authorities with paying bribes of about $2 billion to win large contracts in 12 foreign countries during 2000–2006.

Much of the crisis in residential real estate that emerged in the United States in 2007–2008 stemmed from consciously unethical strategies at certain banks and mortgage companies to boost the fees they earned on home mortgages by deliberately lowering lending standards to grant home loans to people whose incomes were insufficient to make their monthly mortgage payments. Once these banks and mortgage companies earned the fees on the so-called subprime loans they made to unqualified borrowers, they secured the assistance of investment banking firms to bundle these and other home mortgages into collateralized debt obligations and mortgage-backed securities, found means of having these high-risk securities assigned triple-A bond ratings, and auctioned them to unsuspecting investors, who later suffered huge losses when the borrowers began to default on their loan payments. The consequences of crafting strategies that cannot pass the test of moral scrutiny are manifested in sharp drops in stock price that cost shareholders billions of dollars, devastating public relations hits, sizeable fines, and criminal indictments and convictions of company executives.

Drivers of Unethical Strategies and Business Behavior

Apart from "the business of business is business, not ethics" kind of thinking apparent in recent high-profile business scandals, three other main drivers of unethical business behavior also stand out:[2]

- Faulty oversight by top management and the board of directors that implicitly allows the overzealous pursuit of personal gain, wealth, and other self-interests.
- Heavy pressures on company managers to meet or beat performance targets.
- A company culture that puts profitability and good business performance ahead of ethical behavior.

OVERZEALOUS PURSUIT OF PERSONAL GAIN, WEALTH, AND SELF-INTERESTS People who are obsessed with wealth accumulation, greed, power, status, and other self-interests often push ethical principles aside in their quest for personal gain. Driven by their ambitions, they exhibit few qualms in skirting the rules or doing whatever is necessary to achieve their goals. A general disregard for business ethics can prompt all kinds of unethical strategic maneuvers and behaviors at companies. According to a civil complaint filed by the Securities and Exchange Commission, the chief executive officer (CEO) of Tyco International, a well-known $35.6 billion manufacturing and services company, conspired with the company's CFO to steal more than $170 million, including a company-paid $2 million birthday

[2] For survey data on what managers say about why they sometimes behave unethically, see John F. Veiga, Timothy D. Golden, and Kathleen Dechant, "Why Managers Bend Company Rules," *Academy of Management Executive* 18, no. 2 (May 2004), pp. 84–89.

party for the CEO's wife held on Sardinia, an island off the coast of Italy; a $7 million Park Avenue apartment for his wife; and secret low-interest and interest-free loans to fund private businesses and investments and purchase lavish artwork, yachts, estate jewelry, and vacation homes in New Hampshire, Connecticut, Nantucket, and Park City, Utah. Tyco's CEO and CFO were further charged with conspiring to reap more than $430 million from sales of stock, using questionable accounting to hide their actions, and engaging in deceptive accounting practices to distort the company's financial condition from 1995 to 2002. Both Tyco executives were convicted on multiple counts of looting the company in 2005. Concepts & Connections 9.1 discusses how the overzealous pursuit of personal gain, wealth, and self-interests played a role in the fraudulent investment schemes at Bernard L. Madoff Investment Securities and alleged at Stanford Financial Group.

HEAVY PRESSURES ON COMPANY MANAGERS TO MEET OR BEAT EARNINGS TARGETS Performance expectations of Wall Street analysts and investors may create enormous pressure on management to do whatever it takes to sustain the company's reputation for delivering good financial performance. Executives at high-performing companies know that investors will see the slightest sign of a slowdown in earnings growth as a red flag, which could begin a mass sell-off of the company's stock. In addition, slowing growth or declining profits could lead to a downgrade of the company's credit rating if it has used lots of debt to finance its growth. The pressure to watch the scoreboard and "never miss a quarter"—so as not to upset the expectations of Wall Street analysts, stock market investors, and creditors—prompts near-sighted managers to cut discretionary costs that create greater customer value, squeeze extra sales out of early deliveries, and engage in other short-term maneuvers to make the numbers. As the pressure builds to "meet or beat the numbers," company personnel start stretching the rules further and further, until the limits of ethical conduct are overlooked.[3]

Several top executives at WorldCom were convicted of concocting a fraudulent $11 billion accounting scheme to hide costs and inflate revenues and profit over several years; the scheme was said to have helped the company keep its stock price propped up high enough to make additional acquisitions, support its nearly $30 billion debt load, and allow executives to cash in on their lucrative stock options. HealthSouth's chief financial managers were convicted of overstating the company's earnings by $1.4 billion between 1996 and 2002 in an attempt to hide the company's slowing growth from investors. A 2007 internal investigation at Dell Computer found that executives had engaged in a scheme to manipulate the company's accounting data to meet investors' quarterly earnings expectations. The fraudulent accounting practices inflated the company's earnings by $150 million between 2002 and 2006. The executives were terminated by Dell Computer in 2007.

The fundamental problem with a "make the numbers and move on" syndrome is that a company doesn't really create additional value for customers or improve its competitiveness in the marketplace, which are the most reliable

[3] For more details see Ronald R. Sims and Johannes Brinkmann, "Enron Ethics (Or: Culture Matters More than Codes)," *Journal of Business Ethics* 45, no. 3 (July 2003), pp. 244–246.

Concepts & Connections 9.1

INVESTMENT FRAUD AT BERNARD L MADOFF INVESTMENT SECURITIES AND STANFORD FINANCIAL GROUP

Bernard Madoff engineered the largest investment scam in history to accumulate a net worth of more than $800 million and build a reputation as one of Wall Street's most savvy investors—he was appointed to various Securities and Exchange Commission panels, invited to testify before Congress on investment matters, made chairman of Nasdaq, and befriended by some of the world's most influential people. Madoff deceived Wall Street and investors with a simple Ponzi scheme that promised investors returns that would beat the market by 400 to 500 percent. The hedge funds, banks, and wealthy individuals that sent Bernard L. Madoff Investment Securities billions to invest on their behalf were quite pleased when their statements arrived showing annual returns as high as 45 percent. But, in fact, the portfolio gains shown on these statements were fictitious. Funds placed with Bernard Madoff were apparently seldom, if ever, actually invested in any type of security—the money went to cover losses in his legitimate stock trading business, fund periodic withdrawals of investors' funds, and support Madoff's lifestyle (including vacation homes in Montauk, New York, Palm Beach, Florida, Cap d'Antibes, France; a $7 million Manhattan condominium; yachts; and luxury cars).

For decades, the Ponzi scheme was never in danger of collapse because most Madoff investors were so impressed with the reported returns that they seldom made withdrawals from their accounts, and when they did withdraw funds Madoff used the monies being deposited by new investors to cover the payments. Madoff's deception came to an end in late 2008 when the dramatic drop in world stock prices caused so many of Madoff's investors to request withdrawals of their balances that there was not nearly enough new money coming in to cover the amounts being withdrawn. As with any Ponzi scheme, the first to ask Madoff for their funds were paid, but those asking later were left empty-handed. All told, more than 1,300 account holders lost about $65 billion when Bernard Madoff admitted to the scam in December 2008. Madoff was sentenced to 150 years in prison for his crimes. As of June 2009, investigators had located assets of only about $1 billion to return to Madoff account holders.

Increased oversight at the Securities and Exchange Commission after the December 2008 Madoff confession led to the June 2009 indictment of R. Allen Stanford and five others who were accused of running an investment scheme similar to that perpetrated by Bernard Madoff. Stanford was alleged to have defrauded more than 30,000 Stanford Financial Group account holders out of $7 billion through the sale of spurious certificates of deposit (CDs). The CDs marketed by Stanford Financial Group were issued by the company's Antiguan subsidiary, Stanford International Bank, and carried rates that were as much as three to four times greater than the CD rates offered by other financial institutions. Stanford claimed that the Stanford International Bank was able to provide such exceptional yields because of its investment in a globally diversified portfolio of stocks, bonds, commodities, and alternative investments and because of the tax advantages provided by the bank's location in Antigua. All of the investments made by Stanford International Bank were said to be safe and liquid financial instruments monitored by more than 20 analysts and audited by Antiguan regulators. In fact, the deposits were invested in much riskier private equity placements and real estate investments and were subject to severe fluctuations in value. The statements provided to CD holders were alleged by prosecutors to be based upon fabricated performance and phony financial statements.

Federal prosecutors also alleged that deposits of at least $1.6 billion were diverted into undisclosed personal loans to Allen Stanford. At the time of Stanford's indictment, he ranked 605th on *Forbes* magazine's list of the world's wealthiest persons with an estimated net worth of $2.2 billion. Stanford was a notable sports enthusiast and philanthropist—he supported a cricket league in Antigua and professional golf tournaments in the United States and contributed millions to the St. Jude Children's Research Hospital and museums in Houston and Miami. Stanford also pledged $100 million to support programs aimed at slowing global warming. Allen Stanford and Bernard Madoff were also major contributors to political candidates, with Madoff's largest contributions going to New York Senator Charles Schumer

continued

Concepts & Connections 9.1 *continued*

and New Jersey Senator Frank Lautenberg. Stanford's major donations went to presidential candidates Barack Obama and John McCain, Florida Senator Bill Nelson, and Texas Representative Pete Sessions. Stanford was also a major political contributor in Antigua where he held dual citizenship and was bestowed with knighthood. In May 2009, Stanford Investment Bank disclosed that it owed $7.2 billion to about 28,000 account holders. Its total assets at the time stood at $1 billion, including $46 million in cash.

Sources: James Bandler, Nicholas Varchaver, and Doris Burke, "How Bernie Did It," *Fortune Online,* April 30, 2009 (accessed July 7, 2009); Duncan Greenberg, "Billionaire Responds to SEC Probe," *Forbes Online,* February 13, 2009 (accessed July 9, 2009); Katie Benner, "Stanford Scandal Sets Antigua on Edge," *Fortune Online,* February 25, 2009 (accessed July 9, 2009); Alyssa Abkowitz, "The Investment Scam-Artist's Playbook," *Fortune Online,* February 25, 2009 (accessed July 9, 2009); Kathryn Glass, "Stanford Bank Assets Insufficient to Repay Depositors," Fox Business.com, May 15, 2009 (accessed July 9, 2009); and Bill McQuillen, Justin Blum, and Laurel Brubaker Calkins, "Allen Stanford Indicted by U.S. in $7 Billion Scam," Bloomberg.com, June 19, 2009 (accessed July 9, 2009).

drivers of higher profits and added shareholder value. Cutting ethical corners or stooping to downright illegal actions in the name of profits first carries exceptionally high risk for shareholders—a steep stock price decline and a tarnished brand image that leaves a company worth much less than before.

COMPANY CULTURES THAT PUT THE BOTTOM LINE AHEAD OF ETHICAL BEHAVIOR When a company's culture spawns an ethically corrupt or amoral work climate, people have a company approved license to ignore "what's right" and engage in most any behavior they think they can get away with.[4] At such companies, ethically immoral or amoral people are given free reign and otherwise honorable people may succumb to the many opportunities around them to engage in unethical practices. A perfect example of a company culture gone awry on ethics is Enron.[5] Enron's annual "rank and yank" performance evaluation process where the 15 to 20 percent lowest-ranking employees were let go or encouraged to seek other employment made it abundantly clear that bottom-line results were what mattered most. Survival at Enron relied, to some extent, on devising clever ways to boost revenues and earnings—even if it sometimes meant operating outside established policies and without the knowledge of superiors.

The underpinnings of Enron's culture that encouraged unethical behavior were also linked to its reward system. Employees who produced the best bottom-line results received impressively large incentives and bonuses (amounting to as much as $1 million for traders and even more for senior executives). On Car Day at Enron, an array of luxury sports cars arrived for presentation to the most successful employees. Understandably, employees wanted to be seen as part of Enron's star team and partake in the benefits granted to Enron's best and smartest employees. The high monetary rewards, the ambitious and hard-driving people that the company hired and promoted, and the competitive, results-oriented culture combined to give Enron a reputation

[4] Veiga, Golden, and Dechant, "Why Managers Bend Company Rules," p. 85.

[5] The following account is based largely on the discussion and analysis in Sims and Brinkmann, "Enron Ethics," pp. 245–252. Perhaps the definitive book-length account of the corrupt Enron culture is Kurt Eichenwald, *Conspiracy of Fools: A True Story* (New York: Broadway Books, 2005).

not only for trampling competitors at every opportunity but also for internal ruthlessness. The company's super-aggressiveness and win-at-all-costs mindset nurtured a culture that gradually and then more rapidly fostered the erosion of ethical standards, eventually making a mockery of the company's stated values of integrity and respect. When it became evident in the fall of 2001 that Enron was a house of cards propped up by deceitful accounting and a myriad of unsavory practices, the company imploded in a matter of weeks.

The Business Case for Ethical Strategies and Ethical Operating Practices

There are solid business reasons to adopt ethical strategies even if most company managers are not of strong moral character and personally committed to high ethical standards. Pursuing unethical strategies not only damages a company's reputation but it can also have costly consequences that are wide-ranging. Some of the costs are readily visible; others are hidden and difficult to track down—as shown in Figure 9.1. The costs of fines and penalties and any declines in the stock price are easy enough to calculate. The administrative "cleanup" (or Level 2) costs are usually buried in the general costs of doing business and can be difficult to ascribe to any one ethical misdeed. Level 3 costs can be quite difficult to quantify but can sometimes be the most devastating—the aftermath of the Enron debacle left Arthur Andersen's reputation in shreds and led to the once-revered accounting firm's almost immediate

FIGURE 9.1 **The Costs of Business Ethics Failures**

Level 1 Costs	Level 2 Costs	Level 3 Costs
• Government fines and penalties • Civil penalties arising from class-action lawsuits and other litigation aimed at punishing the company for its offense and the harm done to others • The costs to shareholders in the form of a lower stock price	• Legal and investigative costs incurred by the company • The costs of providing remedial education and ethics training to company personnel • Costs of taking corrective actions • Administrative costs associated with ensuring future compliance	• Customer defections • Loss of reputation • Lost employee morale and higher degrees of employee cynicism • Higher employee turnover • Higher recruiting costs and difficulty of attracting talented employees • Adverse effects on employee productivity • The costs of complying with often harsher government regulations

Get more executive attention; visible (and possibly less damaging) costs ⟷ Get less executive attention; hidden (and perhaps more damaging) costs

Source: Adapted from Terry Thomas, John R. Schermerhorn, and John W. Dienhart, "Strategic Leadership of Ethical Behavior," *Academy of Management Executive* 18, no. 2 (May 2004), p. 58.

demise. It remains to be seen whether Merck, once one of the world's most respected pharmaceutical firms, can survive the revelation that senior management deliberately concealed that its Vioxx painkiller, which the company pulled off the market in September 2004, was tied to a high risk of heart attack ands trokes.[6]

Ensuring a Strong Commitment to Business Ethics in Companies with International Operations

Notions of right and wrong, fair and unfair, moral and immoral, ethical and unethical are present in all societies, organizations, and individuals. But there are three schools of thought about the extent to which the ethical standards travel across cultures and whether multinational companies can apply the same set of ethical standards in all of the locations where they operate.

THE SCHOOL OF ETHICAL UNIVERSALISM According to the school of **ethical universalism,** some concepts of what is right and what is wrong are *universal* and transcend most all cultures, societies, and religions.[7] For instance, being truthful strikes a chord of what's right in the peoples of all nations. Ethical norms considered universal by many ethicists include honesty, trustworthiness, respecting the rights of others, practicing the Golden Rule, and avoiding unnecessary harm to workers or to the users of the company's product or service.[8] *To the extent there is common moral agreement about right and wrong actions and behaviors across multiple cultures and countries, there exists a set of universal ethical standards to which all societies, companies, and individuals can be held accountable.* The strength of ethical universalism is that it draws upon the collective views of multiple societies and cultures to put some clear boundaries on what constitutes ethical business behavior no matter what country market its personnel are operating in. This means that in those instances where basic moral standards really do not vary significantly according to local cultural beliefs, traditions, or religious convictions, a multinational company can develop a code of ethics that it applies more or less evenly across its worldwide operations.[9]

According to the school of **ethical universalism,** the same standards of what's ethical and what's unethical resonate with peoples of most societies regardless of local traditions and cultural norms; hence, common ethical standards can be used to judge employee conduct in a variety of country markets and cultural circumstances.

THE SCHOOL OF ETHICAL RELATIVISM Beyond widely accepted ethical norms, many ethical standards likely vary from one country to another because of divergent religious beliefs, social customs, and prevailing political

[6] Anna Wilde Mathews and Barbara Martinez, "E-Mails Suggest Merck Knew Vioxx's Dangers at Early Stage," *The Wall Street Journal*, November 1, 2004, pp. A1 and A10.
[7] For research on what are the universal moral values (six are identified—trustworthiness, respect, responsibility, fairness, caring, and citizenship), see Mark S. Schwartz, "Universal Moral Values for Corporate Codes of Ethics," *Journal of Business Ethics* 59, no. 1 (June 2005), pp. 27–44.
[8] See, for instance, Mark. S. Schwartz, "A Code of Ethics for Corporate Codes of Ethics," *Journal of Business Ethics* 41, nos. 1–2 (November–December 2002), pp. 27–43.
[9] For more discussion of this point, see Schwartz, "A Code of Ethics for Corporate Codes of Ethics," pp. 29–30.

and economic doctrines (whether a country leans more toward a capitalistic market economy or one heavily dominated by socialistic or communistic principles). The school of **ethical relativism** holds that when there are cross-country or cross-cultural differences in what is deemed an ethical or unethical business situation, it is appropriate for local moral standards to take precedence over what the ethical standards may be in a company's home market. The thesis is that whatever a culture thinks is right or wrong really is right or wrong for that culture.[10]

According to the school of **ethical relativism** different societal cultures and customs create divergent standards of right and wrong—thus what is judged ethical or unethical must be judged in the light of local customs and social mores and can vary from one culture or nation to another.

A company that adopts the principle of ethical relativism and holds company personnel to local ethical standards necessarily assumes that what prevails as local morality is an adequate guide to ethical behavior. This can be ethically dangerous—it leads to the conclusion that if a country's culture generally accepts bribery or environmental degradation or exposing workers to dangerous conditions, then managers working in that country are free to engage in such activities. Adopting such a position places a company in a perilous position if it is required to defend these activities to its stakeholders in countries with higher ethical expectations. Moreover, from a global markets perspective, ethical relativism results in a maze of conflicting ethical standards for multinational companies. Imagine, for example, that a multinational company in the name of ethical relativism takes the position that it is okay for company personnel to pay bribes and kickbacks in countries where such payments are customary but forbids company personnel from making such payments in those countries where bribes and kickbacks are considered unethical or illegal. Having thus adopted conflicting ethical standards for operating in different countries, company managers have little moral basis for enforcing ethical standards companywide—rather, the clear message to employees would be that the company has no ethical standards or principles of its own, preferring to let its practices be governed by the countries in which it operates. Table 9.1 presents results of the *2008 Global Corruption Report,* which illustrates the impracticality of tailoring a multinational company's ethical standards to local expectations.

Codes of conduct based upon ethical relativism can be *ethically dangerous* by creating a maze of conflicting ethical standards for multinational companies.

INTEGRATIVE SOCIAL CONTRACTS THEORY Integrative social contracts theory provides yet a middle position between the opposing views of universalism and relativism.[11] According to **integrative social contracts theory,** the ethical standards a company should try to uphold are governed

[10] T. L. Beauchamp and N. E. Bowie, *Ethical Theory and Business* (Upper Saddle River, NJ: Prentice Hall, 2001), p. 8.

[11] Two of the definitive treatments of integrative social contracts theory as applied to ethics are Thomas Donaldson and Thomas W. Dunfee, "Towards a Unified Conception of Business Ethics: Integrative Social Contracts Theory," *Academy of Management Review* 19, no. 2 (April 1994), pp. 252–284; and Thomas Donaldson and Thomas W. Dunfee, *Ties That Bind: A Social Contracts Approach to Business Ethics* (Boston: Harvard Business School Press, 1999) especially Chapters 3, 4, and 6. See, also, Andrew Spicer, Thomas W. Dunfee, and Wendy J. Bailey, "Does National Context Matter in Ethical Decision Making? An Empirical Test of Integrative Social Contracts Theory," *Academy of Management Journal* 47, no. 4 (August 2004), p. 610.

Table9.1

Corruption Perceptions Index, Selected Countries, 2008

COUNTRY	2008 CPI SCORE*	COUNTRY	2008 CPI SCORE*
Denmark	9.3	Taiwan	5.7
New Zealand	9.3	Malaysia	5.1
Sweden	9.3	South Africa	4.9
Singapore	9.2	Italy	4.8
Finland	9.0	Turkey	4.6
Switzerland	9.0	Cuba	4.3
Iceland	8.9	Romania	3.8
Netherlands	8.9	China	3.6
Australia	8.7	Mexico	3.6
Canada	8.7	Brazil	3.5
Luxembourg	8.3	Saudi Arabia	3.5
Austria	8.1	Thailand	3.5
Hong Kong	8.1	India	3.4
Germany	7.9	Argentina	2.9
Japan	7.3	Vietnam	2.7
United States	7.3	Pakistan	2.5
France	6.9	Russia	2.1
Chile	6.9	Venezuela	1.9
Spain	6.5	Haiti	1.4
Israel	6.0	Myanmar	1.3
United Arab Emirates	5.9	Somalia	1.0

***Note:** The CPI scores range between 10 (highly clean) and 0 (highly corrupt); the data draw on information from 13 different polls and surveys from 11 independent institutions. The CPI score represents the perceptions of the degree of corruption as seen by business people, academics, and risk analysts. CPI scores were reported for 180 countries.

Source: Reprinted from 2008 International Annual Report Copyright © 2008 Transparency International: the global condition against corruption. Used with permission. For further information, visit http://www.transparency.org.

According to **integrative social contracts theory,** universal ethical principles based on collective views of multiple cultures combine to form a "social contract" that all employees in all country markets have a duty to observe. Within the boundaries of this social contract, there is room for host country cultures to exert *some* influence in setting their own moral and ethical standards. However, *"first-order"* universal ethical norms always take precedence over *"second-order"* local ethical norms in circumstances where local ethical norms are more permissive.

both by (1) a limited number of universal ethical principles that are widely recognized as putting legitimate ethical boundaries on actions and behavior in *all* situations and (2) the circumstances of local cultures, traditions, and shared values that further prescribe what constitutes ethically permissible behavior and what does not. This "social contract" by which managers in all situations have a duty to serve provides that *"first-order" universal ethical norms always take precedence over "second-order" local ethical norms in circumstances where local ethical norms are more permissive.* Integrative social contracts theory offers managers in multinational companies clear guidance in resolving cross-country ethical differences: Those parts of the company's code of ethics that involve universal ethical norms must be enforced worldwide, but within these boundaries there is room for ethical diversity and opportunity for host country cultures to exert *some* influence in setting their own moral and ethical standards.

A good example of the application of integrative social contracts theory involves the payment of bribes and kickbacks. Yes, bribes and kickbacks seem to be common in some countries, but does this justify paying them? Just because bribery flourishes in a country does not mean that it is an authentic or legitimate ethical norm. Virtually all of the world's major religions (Buddhism, Christianity, Confucianism, Hinduism, Islam, Judaism, Sikhism, and Taoism) and all moral schools of thought condemn bribery and corruption.[12] Therefore, a multinational company might reasonably conclude that the right ethical standard is one of refusing to condone bribery and kickbacks on the part of company personnel no matter what the second-order local norm is and no matter what the sales consequences are. An example of the application of integrative social contracts theory that allows second-order local customs to set ethical boundaries involves employee recruiting and selection practices. A company that has adopted a first-order universal norm of equal opportunity in the workplace might allow applicants to include photographs with resumes in countries where such is the norm. Local country managers in the United States are prohibited by law from accepting employment applications including a photograph, but local country managers in Europe would find it very unusual for an application to not be accompanied by a photograph of the applicant. A policy that prohibited managers from accepting applications containing a photo of the applicant would result in almost all applications being rejected. But even with the guidance provided by integrative social contracts theory, there are many instances where cross-country differences in ethical norms create "gray areas" where it is tough to draw a line in the sand between right and wrong decisions, actions, and business practices.

Social Responsibility and Corporate Citizenship

The idea that businesses have an obligation to foster social betterment, a much-debated topic in the past 40 years, took root in the 19th century when progressive companies in the aftermath of the industrial revolution began to provide workers with housing and other amenities. The notion that corporate executives should balance the interests of all stakeholders—shareholders, employees, customers, suppliers, the communities in which they operated, and society at large—began to blossom in the 1960s. The essence of the theory of **corporate social responsibility** is that a company should strive for balance between (1) its *economic responsibility* to reward shareholders with profits, (2) its *legal responsibility* to comply with the laws of countries where it operates, (3) the *ethical responsibility* to abide by society's norms of what is moral and just, and (4) a *philanthropic responsibility* to contribute to the noneconomic needs of society.[13]

Corporate social responsibility calls for companies to strive for balance between (1) the *economic responsibility* to reward shareholders with profits, (2) the *legal responsibility* to comply with the laws of countries where it operates, (3) the *ethical responsibility* to abide by society's norms of what is moral and just, and (4) the discretionary *philanthropic responsibility* to contribute to the noneconomic needs of society.

[12] P. M. Nichols, "Outlawing Transnational Bribery through the World Trade Organization," *Law and Policy in International Business* 28, no. 2 (1997), pp. 321–322.

[13] Archie B. Carroll, "A Three-Dimensional Conceptual Model of Corporate Performance," *Academy of Management Review* 4, no. 4 (1979), pp. 497–505.

There is unanimous agreement among chief managers of the world's most notable companies that economic, legal, and ethical responsibilities are a *duty* of management and are not subject to debate. In addition, even though such activities are discretionary, most chief managers agree that corporations have a duty to engage in philanthropic activities. Acting in a socially responsible manner thus involves undertaking actions that earn trust and respect from all stakeholders—operating in an honorable and ethical manner, striving to make the company a great place to work, demonstrating genuine respect for the environment, and trying to make a difference in bettering society. Common corporate social responsibility programs involve:

- *Actions to protect the environment and, in particular, to minimize or eliminate any adverse impact on the environment stemming from the company's own business activities*—Social responsibility as it applies to environmental protection means doing more than what is legally required. From a social responsibility perspective, companies have an obligation to be stewards of the environment.
- *Actions to create a work environment that enhances the quality of life for employees*—Numerous companies exert extra efforts to enhance the quality of life for their employees, both at work and at home. This can include on-site day care, flexible work schedules for single parents, workplace exercise facilities, special leaves to care for sick family members, work-at-home opportunities, gender pay equity, and the like.
- *Actions to build a workforce that is diverse with respect to gender, race, national origin, and perhaps other aspects that different people bring to the workplace*—Most large companies in the United States have established workforce diversity programs, and some go the extra mile to ensure that their workplaces are attractive to ethnic minorities and inclusive of all groups and perspectives. The pursuit of workforce diversity can be good business. At Coca-Cola, where strategic success depends on getting people all over the world to become loyal consumers of the company's beverages, efforts to build a public persona of inclusiveness for people of all races, religions, nationalities, interests, and talents have considerable strategic value.

Some companies use the terms corporate social responsibility and **corporate citizenship** interchangeably, but there is a body of thought that only companies pursuing discretionary activities in the pursuit of bettering society can be described as good corporate citizens. Adherents of corporate citizenship theories suggest that corporations, as citizens of the communities in which they operate, have an obligation to contribute to society where government has chosen not to focus its efforts or has fallen short.[14] For instance, McDonald's sponsors the Ronald McDonald House Charities program, which provides a home away from home for the families of critically ill children receiving treatment at nearby hospitals. British Telecom

Corporate citizenship requires a corporate commitment to go beyond meeting society's expectations for ethical strategies and business behavior to demonstrating good citizenship by addressing unmet noneconomic needs of society.

[14] Dirk Matten and Andrew Crane, "Corporate Citizenship: Toward an Extended Theoretical Conceptualization," *Academy of Management Review* 30, no. 1 (2005), pp. 166–179.

gives 1 percent of its profits directly to communities, largely for education—teacher training, in-school workshops, and digital technology. Leading prescription drugmaker GlaxoSmithKline and other pharmaceutical companies practice corporate citizenship by either donating or heavily discounting medicines for distribution in the least-developed nations. Companies frequently reinforce their philanthropic efforts by encouraging employees to support charitable causes and participate in community affairs, often through programs that match employee contributions.

Corporate Sustainability and the Environment

There is a rapidly growing set of multinational companies that are expanding their understanding of societal responsibilities to include the impact of their strategies and operations on future generations. **Corporate sustainability** strategies are aimed at meeting the needs of current era customers, suppliers, shareholders, employees, and other stakeholders in a manner that protects the resources needed by future generations and is therefore sustainable for centuries. Sustainability initiatives undertaken by companies are directed at improving the company's triple bottom line (TBL)—its performance on economic, environment, and social metrics.[15] Unilever, a diversified producer of processed foods, personal care, and home cleaning products, is among the most committed corporations pursuing sustainable business practices. The company tracks 11 sustainable agricultural indicators in its processed foods business and has launched a variety of programs to improve the environmental performance of its suppliers. Examples of such programs include special low-rate financing for tomato suppliers choosing to switch to water-conserving irrigation systems and training programs in India that have allowed contract cucumber growers to reduce pesticide use by 90 percent, while improving yields by 78 percent.

Corporate sustainability involves strategic efforts to meet the needs of today's customers, suppliers, shareholders, employees, and other stakeholders in a manner that protects the environment and provides for the longevity of resources needed for future generations.

Unilever has also reengineered many internal processes to improve the company's overall performance on sustainability measures. For example, the company's factories have reduced water usage by 50 percent and manufacturing waste by 14 percent through the implementation of sustainability initiatives. Unilever has also redesigned packaging for many of its products to conserve natural resources and reduce the volume of consumer waste. The company's Suave shampoo bottles in the United States were reshaped to save almost 150 tons of plastic resin per year, which is the equivalent of 15 million fewer empty bottles making it to landfills annually. Also, the width of Unilever's Lipton soup cartons was reduced to save 154 tons of cardboard per year. Because 40 percent of Unilever's sales are made to consumers in developing countries, the company also is committed to addressing societal needs of consumers in those countries. Examples of the company's social performance include free laundries in poor neighborhoods in developing countries, start-up assistance for women-owned micro businesses in India, and free drinking water provided to villages in Ghana.

[15] Gerald I. J., M. Zetsloot, and Marcel N. A. van Marrewijk, "From Quality to Sustainability," *Journal of Business Ethics* 55 (2004), pp. 79–82; and Elkington, John B. *Cannibals with Forks: The Triple Bottom Line of 21st Century Business*, (Oxford: Capstone Publishing, 1997).

Sometimes cost savings and improved profitability are drivers of corporate sustainability strategies. DuPont's sustainability initiatives regarding energy usage have resulted in energy conservation savings of more than $2 billion between 1990 and 2005. Procter & Gamble's Swiffer cleaning system, one of the company's best-selling new products, was developed as a sustainable product; not only does the Swiffer system have an earth-friendly design, but it also outperforms less ecologically friendly alternatives. Although most consumers probably aren't aware that the Swiffer mop reduces demands on municipal water sources, saves electricity that would be needed to heat mop water, and doesn't add to the amount of detergent making its way into waterways and waste treatment facilities, they are attracted to purchasing Swiffer mops because they prefer Swiffer's disposable cleaning sheets to filling and refilling a mop bucket and wringing out a wet mop until the floor is clean.

Most well-known companies discuss their sustainability strategies and results in press releases and special sustainability reports for consumers and investors to review. Just as investment firms have created mutual funds made up of companies passing some threshold of social responsibility, a number of sustainability funds have been created in recent years for environmentally and socially aware investors to purchase. The Dow Jones Sustainability World Index is made up of the top 10 percent of the 2,500 companies listed in the Dow Jones World Index in terms of economic performance, environmental performance, and social performance. Table 9.2 shows companies with exceptional commitments to sustainability (judged according to their being designated as worldwide supersector leaders within the Dow Jones Sustainability World Index for 2008/2009). However, achieving a prominent ranking in sustainability indexes is no guarantee that a company will outperform industry rivals when it comes to social responsibility. For example, BP's $8 billion investment into alternative energy sources and its strong involvement in community and environmental groups had allowed it to consistently rank near the top among sustainability indexes, but between 2005 and 2007 the company was fined for safety violations at an Ohio refinery, was investigated by the U.S. Department of Justice for suspected manipulation of oil prices, had a major oil pipeline leak in Alaska, and was hit with a refinery explosion in Texas that claimed the lives of 15 employees.[16]

Crafting Social Responsibility and Sustainability Strategies

While striving to be socially responsible and to engage in environmentally sustainable business practices, there's plenty of room for every company to make its own statement about what charitable contributions to make, what kinds of community service projects to emphasize, what environmental actions to support, how to make the company a good place to work, where and how workforce diversity fits into the picture, and what else it will do to support worthy causes and projects that benefit society. A company may choose to focus its social responsibility strategy on generic social issues, but social responsibility strategies keyed to points of intersection between a company and society may

[16] BP's environmental record is discussed in "Beyond the Green Corporation," *BusinessWeek*, January 29, 2007, p. 50.

Table 9.2

Companies with Exceptional Commitments to Sustainability

NAME	MARKET SECTOR	COUNTRY
BMW	Automobiles and parts	Germany
Australia & New Zealand Banking Group	Banks	Australia
Xstrata	Basic resources	UK
BASF	Chemicals	Germany
Holcim	Construction and materials	Switzerland
Itausa-Investimentos Itau	Financial services	Brazil
Unilever	Food and beverages	Netherlands
Novartis	Health care	Switzerland
TNT N.V.	Industrial goods and services	Netherlands
Swiss Re	Insurance	Switzerland
Pearson	Media	UK
ENI	Oil and gas	Italy
adidas	Athletic footwear, apparel, and equipment	Germany
Land Securities Group	Real estate	UK
Kingfisher	Retail	UK
Intel	Technology	USA
BT Group	Telecommunications	UK
Air France-KLM	Travel and leisure	France
Grupo Iberdrola	Utilities	Spain

Sources: Dow Jones Indexes, STOXX Limited, and SAM Group. Accessed at http://www.sustainability-indexes.com/07_htmle/indexes/djsiworld_supersectorleaders.html, on July 8, 2009.

also contribute to a company's competitive advantage.[17] Almost all activities performed by a company (such as hiring practices, emissions, and waste disposal) have either a positive or negative affect on society. In addition, society affects the competitive environment in which companies operate—society provides a company with labor and transportation infrastructure, sets the rules that govern competition, determines the demand for a company's product or service, and shapes the availability of supporting industries.

Social responsibility strategies that focus on these points of intersection between society and the company's ability to execute various value chain activities or better serve customer needs provide social benefits as well as build competitive advantage. For example, while carbon emissions may be a generic social issue for a financial institution such as Wells Fargo, Toyota's social responsibility strategy aimed at reducing carbon emissions has produced both competitive advantage and environmental benefits. Its Prius hybrid electric/gasoline powered automobile not only is among the least polluting automobiles, but also is the best-selling hybrid vehicle in the United States and

[17] For an excellent discussion of crafting corporate social responsibility strategies capable of contributing to a company's competitive advantage, see Michael E. Porter and Mark R. Kramer, "Strategy & Society: The Link between Competitive Advantage and Corporate Social Responsibility," *Harvard Business Review* 84, no. 12 (December 2006), pp. 78–92.

Social responsibility strategies that have the effect of both providing valuable social benefits and fulfilling customer needs in a superior fashion can lead to competitive advantage. Corporate social agendas that address generic social issues may help boost a company's reputation, but are unlikely to improve its competitive strength in the marketplace.

has earned the company the loyalty of fuel-conscious buyers and given Toyota a green image.

Green Mountain Coffee Roasters' commitment to protect the welfare of coffee growers and their families (in particular, making sure they receive a fair price) also intersects with the company's competitively important value chain activities. In its dealings with suppliers at small farmer cooperatives in Peru, Mexico, and Sumatra, Green Mountain pays "fair trade" prices for coffee beans (in 2008, the fair trade prices were a minimum of $1.39 per pound for conventional coffee versus market prices of $1.10 per pound). Green Mountain also purchases about 25 percent of its coffee direct from farmers so as to cut out intermediaries and see that farmers realize a higher price for their efforts—coffee is the world's second most heavily traded commodity after oil, requiring the labor of some 20 million people, most of whom live at the poverty level.[18] At Marriott, the company's social agenda includes providing 180 hours of paid classroom and on-the-job training to the chronically unemployed. Ninety percent of the graduates from the job training program take jobs with Marriott and about two-thirds of those remain with Marriott for more than a year. Patagonia encourages customers to return worn-out cotton, fleece, and nylon clothing items so that the fibers can be recycled into fabrics for new clothing items.

Whole Foods Market's social responsibility strategy is evident in almost every segment of its company value chain and is a big part of its differentiation strategy. The company's procurement policies encourage stores to purchase fresh fruits and vegetables from local farmers and screen processed food items for more than 100 common ingredients that the company considers unhealthy or environmentally unsound. Spoiled food items are sent to regional composting centers rather than landfills and all cleaning products used in its stores are biodegradable. The company also has created the Animal Compassion Foundation to develop natural and humane ways of raising farm animals and has converted all of its vehicles to run on biofuels.

However, not all companies choose to link their corporate social agendas to their own business or industry. Chick-Fil-A, an Atlanta-based fast-food chain with over 1,200 outlets in 38 states, has a charitable foundation that supports 14 foster homes and a summer camp for some 1,800 campers from 22 states and several foreign countries.[19] Levi Strauss & Company has made HIV/AIDS prevention and awareness a major component of its social agenda for a number of years. Some of the programs funded by the company and the Levi Strauss Foundation having little to do with its business activities include its financial support of Syringe Access Fund that makes sterile syringes available to intravenous

[18] World Business Council for Sustainable Development, "Corporate Social Responsibility: Making Good Business Sense," January 2000, p. 7, accessed October 10, 2003 at www.wbscd.ch. For a discussion of how companies are connecting social initiatives to their core values, see David Hess, Nikolai Rogovsky, and Thomas W Dunfee, "The Next Wave of Corporate Community Involvement: Corporate Social Initiatives," *California Management Review* 44, no. 2 (Winter 2002), pp. 110–125; Susan Ariel Aaronson, "Corporate Responsibility in the Global Village: The British Role Model and the American Laggard," *Business and Society Review* 108, no. 3 (September 2003), p. 323.

[19] www.chick-fil-a.com, accessed November 4, 2005.

drug users in the United States and the funding of cartoons directed at children between the ages 8 and 10 that discuss how to best prevent the transmission of the AIDS virus. The Preventoons cartoons were distributed to more than 20,000 teachers in Argentina and Uruguay to use in their classrooms.

It is common for companies engaged in natural resource extraction, electric power production, forestry and paper products, motor vehicles, and chemicals production to place more emphasis on addressing environmental concerns than, say, software and electronics firms or apparel manufacturers. Companies whose business success is heavily dependent on high employee morale or attracting and retaining the best and brightest employees are somewhat more prone to stress the well-being of their employees and foster a positive, high-energy workplace environment that elicits the dedication and enthusiastic commitment of employees, thus putting real meaning behind the claim "Our people are our greatest asset." Ernst & Young, one of the four largest global accounting firms, stresses its "People First" workforce diversity strategy that is all about respecting differences, fostering individuality, and promoting inclusiveness so that its 105,000 employees in 140 countries can feel valued, engaged, and empowered in developing creative ways to serve the firm's clients. Thus, while the strategies and actions of all socially responsible companies have a sameness in the sense of making discretionary contributions to noneconomic societal needs, each company's version of being socially responsible is unique.

The Business Case for Socially Responsible Behavior

Whatever the moral arguments for socially responsible business behavior, it has long been recognized that it is in the enlightened self-interest of companies to be good citizens and devote some of their energies and resources to the betterment of employees, the communities in which they operate, and society in general. In short, there are several reasons why the exercise of corporate social responsibility and corporate citizenship is good business:

- *It generates internal benefits (particularly concerning employee recruiting, workforce retention, and training costs)*—Companies with good reputations for contributing time and money to the betterment of society are better able to attract and retain employees compared to companies with tarnished reputations. Some employees just feel better about working for a company committed to improving society.[20] This can contribute to lower turnover and better worker productivity. Other direct and indirect economic benefits include lower costs for staff recruitment and training. For example, Starbucks is said to enjoy much lower rates of employee turnover because of its full benefits package for both full-time and part-time employees, management efforts to make Starbucks a great place to work, and the company's socially responsible practices.

[20] N. Craig Smith, "Corporate Social Responsibility: Whether and How," *California Management Review* 45, no. 4 (Summer 2003), p. 63; see also, World Economic Forum, "Findings of a Survey on Global Corporate Leadership," accessed at www.weforum.org/corporatecitizenship, October 11, 2003.

- *It reduces the risk of reputation-damaging incidents and can lead to increased buyer patronage*—Firms may well be penalized by employees, consumers, and shareholders for actions that are not considered socially responsible. Consumer, environmental, and human rights activist groups are quick to criticize businesses whose behavior they consider to be out of line, and they are adept at getting their message into the media and onto the Internet. Pressure groups can generate widespread adverse publicity, promote boycotts, and influence like-minded or sympathetic buyers to avoid an offender's products. Research has shown that product boycott announcements are associated with a decline in a company's stock price.[21]I nc ontrast, to the extent that a company's socially responsible behavior wins applause from consumers and fortifies its reputation, the company may win additional patronage. Some observers and executives are convinced that a strong, visible, social responsibility strategy gives a company an edge in differentiating itself from rivals and in appealing to those consumers who prefer to do business with companies that are solid corporate citizens. Whole Foods Market, Patagonia, Chick-Fil-A, Starbucks, and Green Mountain Coffee Roasters have definitely expanded their customer bases because of their visible and well-publicized activities as socially conscious companies. Yet there is only limited evidence that consumers go out of their way to patronize socially responsible companies if it means paying a higher price or purchasing an inferior product.[22]
- *It is in the best interest of shareholders*—Well-conceived social responsibility strategies help avoid or preempt legal and regulatory actions that could prove costly and otherwise burdensome. Stock prices of companies taking the straight and narrow path and rating high on social and environmental performance criteria have performed 35 to 45 percent better than the average of the 2,500 companies on the Dow Jones Global Index.[23]Ne arly100 studies have examined the relationship between corporate citizenship and corporate financial performance over the past 30 years; the majority point to a positive relationship. Of the 80 studies that examined whether a company's social performance is a good predictor of its financial performance, 42 concluded yes, 4 concluded no, and the remainder reported mixed or inconclusivef indings.[24]

[21] Wallace N. Davidson, Abuzar El-Jelly, and Dan L. Worrell, "Influencing Managers to Change Unpopular Corporate Behavior through Boycotts and Divestitures: A Stock Market Test," *Business and Society* 34, no. 2 (1995), pp. 171–196.
[22] Smith, "Corporate Social Responsibility," p. 62.
[23] See James C. Collins and Jerry I. Porras, *Built to Last: Successful Habits of Visionary Companies*, 3rd ed. (London: HarperBusiness, 2002); Sarah Roberts, Justin Keeble, and David Brown, "The Business Case for Corporate Citizenship," a study for the World Economic Forum, www.weforum.org/corporatecitizenship, October 14, 2003, p. 4; and Smith, "Corporate Social Responsibility," p. 63.
[24] Smith, "Corporate Social Responsibility," p. 65; Lee E. Preston and Douglas P. O'Bannon, "The Corporate Social-Financial Performance Relationship," *Business and Society* 36, no. 4 (December 1997), pp. 419–429; Ronald M. Roman, Sefa Hayibor, and Bradley R. Agle, "The Relationship between Social and Financial Performance: Repainting a Portrait," *Business and Society*, 38, no. 1 (March 1999), pp. 109–125; and Joshua D. Margolis and James P. Walsh, *People and Profits* (Mahwah, NJ: Lawrence Erlbaum, 2001).

In sum, companies that take social responsibility seriously can improve their business reputations and operational efficiency while also reducing their risk exposure and encouraging loyalty and innovation. Overall, companies that take special pains to protect the environment (beyond what is required by law), are active in community affairs, and are generous supporters of charitable causes and projects that benefit society are more likely to be seen as good investments and as good companies to work for or do business with. Shareholders are likely to view the business case for social responsibility as a strong one, even though they certainly have a right to be concerned about whether the time and money their company spends to carry out its social responsibility strategy outweighs the benefits and reduces the bottom line by an unjustified amount.

KeyP oints

Ethics involves concepts of right and wrong, fair and unfair, moral and immoral. Beliefs about what is ethical serve as a moral compass in guiding the actions and behaviors of individuals and organizations. Ethical principles in business are not materially different from ethical principles in general.

1. The three main drivers of unethical business behavior also stand out:
   - Overzealous or obsessive pursuit of personal gain, wealth, and other selfish interests.
   - Heavy pressures on company managers to meet or beat earnings targets.
   - A company culture that puts profitability and good business performance ahead of ethical behavior.
2. Business ethics failures can result in Level 1 costs (fines, penalties, civil penalties arising from lawsuits, stock price declines), the administrative "cleanup" (or Level 2) costs, and Level 3 costs (customer defections, loss of reputation, higher turnover, harsher government regulations).
3. There are three schools of thought about ethical standards for companies with international operations:
   - Accordingt ot he *school of ethical universalism,* the same standards of what's ethical and unethical resonate with peoples of most societies regardless of local traditions and cultural norms; hence, common ethical standards can be used to judge the conduct of personnel at companies operating in a variety of international markets and cultural circumstances.
   - Accordingt ot he *school of ethical relativism,* different societal cultures and customs have divergent values and standards of right and wrong—thus what is ethical or unethical must be judged in the light of local customs and social mores and can vary from one culture or nation to another.

- Accordingt o *integrative social contracts theory,* universal ethical principles or norms based on the collective views of multiple cultures and societies combine to form a "social contract" that all individuals in all situations have a duty to observe. Within the boundaries of this social contract, local cultures can specify other impermissible actions; however, universal ethical norms always take precedence over local ethical norms.

4. The concept of corporate social responsibility calls for companies to find balance between (1) their *economic responsibilities* to reward shareholders with profits, (2) *legal responsibilities* to comply with the laws of countries where they operate, (3) *ethical responsibilities* to abide by society's norms of what is moral and just, and (4) *philanthropic responsibilities* to contribute to the noneconomic needs of society.
5. Some companies use the terms *corporate social responsibility* and *corporate citizenship* interchangeably, but typically, corporate citizenship places expectations on companies to go beyond consistently demonstrating ethical strategies and business behavior by addressing unmet noneconomic needs of society.
6. *Corporate sustainability* involves strategic efforts to meet the needs of current customers, suppliers, shareholders, employees, and other stakeholders in a manner that protects the environment, provides for the longevity of natural resources, and maintains ecological support systems for future generations.
7. The business case for corporate social responsibility is supported by the following benefits.

    - *It generates internal benefits (particularly concerning employee recruiting, workforce retention, and training costs)*—Companies with good reputations for contributing time and money to the betterment of society are better able to attract and retain employees compared to companies with tarnished reputations. Other direct and indirect economic benefits include lower costs for staff recruitment and training.
    - *It reduces the risk of reputation-damaging incidents and can lead to increased buyer patronage*—Firms may well be penalized by employees, consumers, and shareholders for actions that are not considered socially responsible. Consumer, environmental, and human rights activist groups are quick to criticize businesses whose behavior they consider to be out of line, and they are adept at getting their message into the media and onto the Internet. Pressure groups can generate widespread adverse publicity, promote boycotts, and influence like-minded or sympathetic buyers to avoid an offender's products.
    - *It is in the best interest of shareholders*—Well-conceived social responsibility strategies help avoid or preempt legal and regulatory actions that could prove costly and otherwise burdensome. Taking the straight and narrow path has allowed the stock prices of companies rating high on social and environmental performance criteria to perform 35 to 45 percent better than the average of the 2,500 companies comprising the Dow Jones Global Index.[25]

[25] See Collins and Porras, *Built to Last: Successful Habits of Visionary Companies;* Roberts, Keeble, and Brown, "The Business Case for Corporate Citizenship," p. 4; and Smith, "Corporate Social Responsibility," p. 63.

Assurance of Learning Exercises

LO4 1. Assume that you are the sales manager at a European company that makes sleepwear products for children. Company personnel discover that the chemicals used to flameproof the company's line of children's pajamas might cause cancer if absorbed through the skin. Following this discovery, the pajamas are then banned from sale in the European Union and the United States, but senior executives of your company learn that the children's pajamas in inventory and the remaining flameproof material can be sold to sleepwear distributors in certain East European countries where there are no restrictions against the material's use. Your superiors instruct you to make the necessary arrangements to sell the inventories of banned pajamas and flameproof materials to East European distributors. Would you comply if you felt that your job would be in jeopardy if you didn't?

LO5 2. Review Microsoft's statements about its corporate citizenship programs at www.microsoft.com/about/corporatecitizenship. How does the company's commitment to global citizenship provide positive benefits for its stakeholders? How does Microsoft plan to improve social and economic empowerment in developing countries through its Unlimited Potential program? Why is this important to Microsofts hareholders?

LO5 3. Go to www.nestle.com and read the company's latest sustainability report. What are Nestlé's key sustainable environmental policies? How is the company addressing sustainable social development? How do these initiatives relate to the company's principles, values, and culture and its approach to competing in the food industry?

Exercisesf or Simulation Participants

LO1
LO5 1. Is your company's strategy ethical? Why or why not? Is there anything that your company is doing that could be considered as "shady" by your competitiors?

2. In what ways, if any, is your company exercising social responsibility and good corporate citizenship? Could (should) the list of things your company is doing be longer? If so, indicate what additional actions you think your company ought to considert aking

3. Is your company conducting its business in an environmentally sustainable manner? What specific actions could your company take that would make an even greater contribution to environmental sustainability?

Chapter 10

Superior Strategy Execution—Another Path to Competitive Advantage

Chapter Learning Objectives

LO1. Gain command of what managers must do to build an organization capable of good strategy execution.

LO2. Learn why resource allocation should always be based on strategic priorities.

LO3. Understand why policies and procedures should be designed to facilitate good strategy execution.

LO4. Understand why and how the tools for continuously improving the performance of value chain activities help an organization achieve operating excellence.

LO5. Recognize the role of information and operating systems in enabling company personnel to carry out their strategic roles proficiently.

LO6. Learn how and why the use of well-designed incentives and rewards can be management's single most powerful tool for promoting operating excellence.

LO7. Gain an understanding of how and why a company's culture can aid the drive for proficient strategy execution and operating excellence.

LO8. Understand what constitutes effective managerial leadership in achieving superior strategy execution.

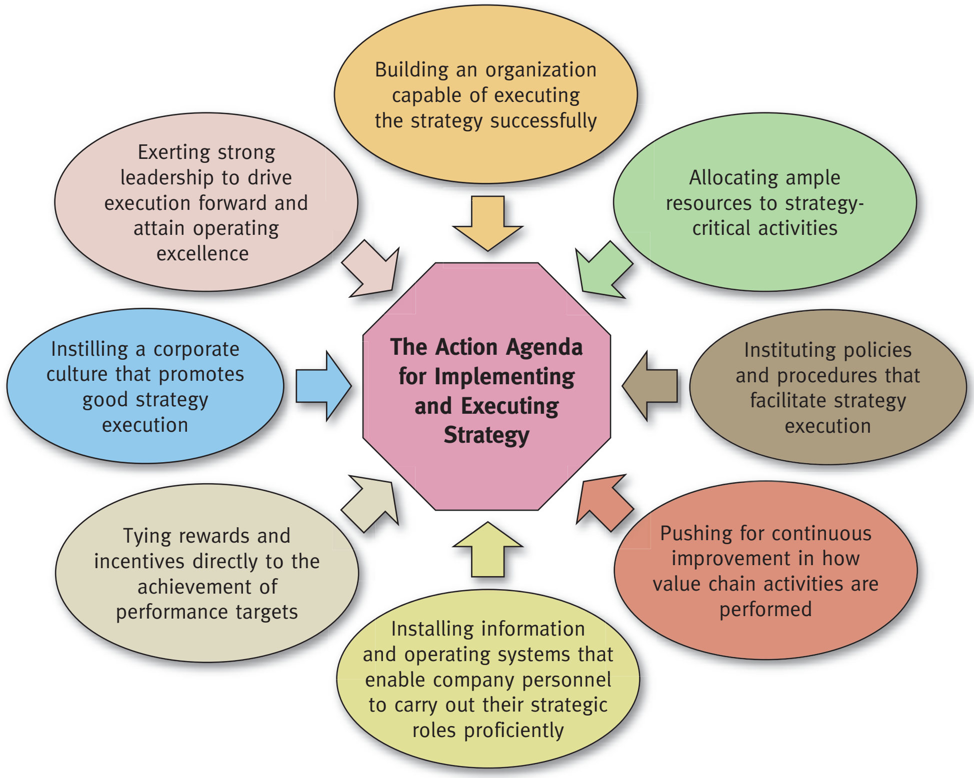
Once managers have decided on a strategy, the emphasis turns to converting it into actions and good results. Putting the strategy into place and getting the organization to execute it well call for different sets of managerial skills. Whereas crafting strategy is largely a market-driven activity, implementing and executing strategy is primarily an action-oriented, make-things-happen task that tests a manager's ability to direct organizational change, achieve continuous improvement in operations and business processes, create and nurture a strategy-supportive culture, and consistently meet or beat performance targets. While an organization's chief executive officer and the heads of major units (business divisions, functional departments, and key operating units) are ultimately responsible for seeing that strategy is executed successfully, the process typically affects every part of the firm, from the biggest operating unit to the smallest frontline work group. It is the middle and lower-level managers who ultimately must ensure that work groups and frontline employees do a good job of performing strategy-critical activities and produce the operating results that allow companywide performance targets to be met. *Hence, strategy execution requires every manager to think through the answer to the question: "What does my area have to do to implement its part of the strategic plan, and what should I do to get these things accomplished effectively and efficiently?"*

The Principal Managerial Components of the Strategy Execution Process

Executing strategy entails figuring out the specific techniques, actions, and behaviors that are needed for a smooth strategy-supportive operation and then following through to get things done and deliver results. The exact items that need to be placed on management's action agenda always have to be customized to fit the particulars of a company's situation. The hot buttons for successfully executing a low-cost provider strategy are different from those in executing a high-end differentiation strategy. Implementing and executing a new strategy for a struggling company in the midst of a financial crisis is a different job than improving strategy execution in a company where the execution is already pretty good. While there's no definitive managerial recipe for successful strategy execution that cuts across all company situations and all types of strategies, certain managerial bases have to be covered no matter what the circumstances. Eight managerial tasks crop up repeatedly in company efforts to execute strategy (see Figure 10.1).

1. Building an organization capable of executing the strategy successfully.
2. Allocating ample resources to strategy-critical activities.
3. Ensuring that policies and procedures facilitate rather than impede effective strategy execution.
4. Pushing for continuous improvement in how value chain activities are performed.
5. Installing information and operating systems that enable company personnel to perform essential activities.
6. Tying rewards directly to the achievement of performance objectives.

FIGURE 10.1 **The Eight Components of Strategy Execution**



7. Fostering a corporate culture that promotes good strategy execution.
8. Exerting the internal leadership needed to propel implementation forward.

How well managers perform these eight tasks has a decisive impact on whether the outcome is a spectacular success, a colossal failure, or something in between. In the remainder of this chapter, we will discuss what is involved in performing the eight key managerial tasks that shape the process of implementing and executing strategy.

Building an Organization Capable of Good Strategy Execution

Proficient strategy execution depends heavily on competent personnel, better-than-adequate competitive capabilities, and effective internal organization. Building a capable organization is thus always a top priority in strategy execution. Three types of organization building actions are paramount.

1. *Staffing the organization*—putting together a strong management team and recruiting and retaining employees with the needed experience, technical skills, and intellectual capital.

2. *Building dynamic capabilities and core competencies*—developing proficiencies in performing strategy-critical value chain activities and updating them to match changing market conditions and customer expectations.
3. *Structuring the organization and work effort*—organizing value chain activities and business processes, establishing lines of authority and reporting relationships, and deciding how much decision-making authority to push down to lower-level managers and frontline employees.

Staffingt heO rganization

No company can hope to perform the activities required for successful strategy execution without attracting and retaining talented managers and employees with suitable skills and intellectual capital.

BUILDING MANAGERIAL TALENT Assembling a capable management team is a cornerstone of the organization-building task.[1] While company circumstances sometimes call for different mixes of backgrounds, experiences, management styles, and know-how, *the most important consideration is to fill key managerial slots with people who are good at figuring out what needs to be done and skilled in "making it happen" and delivering good results.*[2] The task of implementing and executing challenging strategic initiatives must be assigned to executives who have the skills and talents to turn their decisions into results that meet or beat the established performance targets. Without a smart, capable, results-oriented management team, the implementation–execution process ends up being hampered by missed deadlines, misdirected or wasteful efforts, and/or managerial ineptness.[3] Weak executives are serious impediments to getting optimal results because they are unable to differentiate between ideas that have merit and those that are misguided.[4] In contrast, managers with strong strategy implementing capabilities have a talent for asking tough, incisive questions. They know enough about the details of the business to be able to challenge and ensure the soundness of the approaches of the people around them, and they can discern whether the resources people are asking for make sense strategically. They are good at getting things done through others, typically by making sure they have the right people under them and that these people are put in the right jobs.[5] They consistently follow through on issues and do not let important details slip through the cracks.

Sometimes a company's existing management team is suitable; at other times it may need to be strengthened or expanded by promoting qualified

[1] For an insightful discussion of how important it is to staff an organization with the right people, see Christopher A. Bartlett and Sumantra Ghoshal, "Building Competitive Advantage through People," *MIT Sloan Management Review* 43, no. 2 (Winter 2002), pp. 34–41.

[2] The importance of assembling an executive team with exceptional ability to see what needs to be done and an instinctive talent for figuring out how to get it done is discussed in Justin Menkes, "Hiring for Smarts," *Harvard Business Review* 83, no. 11 (November 2005), pp. 100–109; and Justin Menkes, *Executive Intelligence* (New York: HarperCollins, 2005), especially Chapters 1–4.

[3] See Larry Bossidy and Ram Charan, *Execution: The Discipline of Getting Things Done* (New York: Crown Business, 2002) Chapter 1.

[4] Menkes, *Executive Intelligence*, pp. 68, 76.

[5] Bossidy and Charan, *Execution: The Discipline of Getting Things Done*, Chapter 5.

people from within or by bringing in outsiders. The overriding aim in building a management team should be to assemble a *critical mass* of talented managers who can function as agents of change and further the cause of first-rate strategy execution.[6] When a first-rate manager enjoys the help and support of other first-rate managers, it's possible to create a managerial whole that is greater than the sum of individual efforts—talented managers who work well together as a team can produce organizational results that are dramatically better than what one or two star managers acting individually can achieve.[7]

RECRUITING AND RETAINING A CAPABLE WORKFORCE

Assembling a capable management team is not enough. Staffing the organization with the right kinds of people must go much deeper than managerial jobs in order for value chain activities to be performed competently. *The quality of an organization's people is always an essential ingredient of successful strategy execution—knowledgeable, engaged employees are a company's best source of creative ideas for the nuts-and-bolts operating improvements that lead to operating excellence.* Companies like Microsoft and Southwest Airlines make a concerted effort to recruit the best and brightest people they can find and then retain them with excellent compensation packages, opportunities for rapid advancement and professional growth, and challenging and interesting assignments. Having a pool of "A players" with strong skill sets and lots of brainpower is essential to their business. Microsoft makes a point of hiring the very brightest and most talented programmers it can find and motivating them with both good monetary incentives and the challenge of working on cutting-edge software design projects. The leading global accounting firms screen candidates not only on the basis of their accounting expertise but also on whether they possess the people skills needed to relate well with clients and colleagues. Southwest Airlines goes to considerable lengths to hire people who can have fun and be fun on the job; it uses special interviewing and screening methods to gauge whether applicants for customer-contact jobs have outgoing personality traits that match its strategy of creating a high-spirited, fun-loving, in-flight atmosphere for passengers. Southwest Airlines is so selective that only about 3 percent of the people who apply are offered jobs.

The tactics listed below are common among companies dedicated to staffing jobs with the best people they can find:

1. Putting forth considerable effort in screening and evaluating job applicants—selecting only those with suitable skill sets, energy, initiative, judgment, aptitudes for learning, and adaptability to the company's culture.
2. Investing in training programs that continue throughout employees' careers.
3. Providing promising employees with challenging, interesting, and skill-stretchingas signments.

[6] Menkes, *Executive Intelligence*, pp. 65–71.

[7] Jim Collins, *Good to Great* (New York: HarperBusiness, 2001), p. 44.

4. Rotating people through jobs that span functional and geographic boundaries.
5. Striving to retain talented, high-performing employees via promotions, salary increases, performance bonuses, stock options and equity ownership, fringe benefit packages, and other perks.
6. Coaching average performers to improve their skills and capabilities, while weeding out underperformers and benchwarmers.

Building Dynamic Capabilities and Core Competencies

High among the organization-building priorities in the strategy implementing/executing process is the need to build and strengthen competitively valuable capabilities and core competencies. Whereas managers identify the desired capabilities and competencies in the course of crafting strategy, good strategy execution requires putting the desired capabilities and competencies in place, upgrading them as needed, and then modifying them as market conditions evolve.[8] Sometimes a company already has some semblance of the needed competencies and capabilities, in which case managers can concentrate on strengthening and nurturing them to promote better strategy execution. More often, however, company managers have to significantly broaden or deepen certain capabilities or even add entirely new competencies in order to put strategic initiatives in place and execute them proficiently.

Competencies and capabilities that grow stale can impair competitiveness unless they are refreshed, modified, or even phased out and replaced in response to ongoing market changes and shifts in company strategy. Indeed, the buildup of knowledge and experience over time, coupled with the imperatives of keeping capabilities in step with ongoing strategy and market changes, makes it appropriate to view a company as a bundle of evolving capabilities and competencies. Management's organization-building challenge is one of deciding when and how to recalibrate existing competencies and capabilities, and when and how to develop new ones.

Building dynamic capabilities and core competencies is a multistage process that occurs over months and years, not something that is accomplished overnight.

Toyota, en route to overtaking General Motors as the global leader in motor vehicles, has aggressively upgraded its capabilities in fuel-efficient hybrid engine technology and constantly fine-tuned its famed Toyota Production System to enhance its already proficient capabilities in manufacturing top quality vehicles at relatively low costs. Likewise, Honda, which has long had a core competence in gasoline engine technology and small engine design, has recently accelerated its efforts to broaden its expertise and capabilities in hybrid engines so as to stay close behind Toyota. Microsoft totally retooled the manner in which its programmers attacked the task of writing code for its Vista operating systems for PCs and servers.

[8] The importance of developing dynamic capabilities to cope with external changes is discussed in David J. Teece, Gary Pisano, and Amy Shuen, "Dynamic Capabilities and Strategic Management," *Strategic Management Journal* 18, no. 7 (1997), pp. 509–533; and Constance E. Helfat and Margaret A. Peteraf, "The Dynamic Resource-Based View: Capability Lifecycles," *Strategic Management Journal* 24, no. 10 (2003), pp. 997–1010.

Matching Organizational Structure to the Strategy

Building an organization capable of good strategy execution also relies on an organizational structure that lays out lines of authority and reporting relationships in a manner that supports the company's key strategic initiatives. The best approach to settling on an organizational structure is to first consider the key value chain activities that deliver value to the customer. In any business, some activities in the value chain are always more critical than others. For instance, hotel/motel enterprises have to be good at fast check-in/check-out, housekeeping, food service, and creating a pleasant ambience. In specialty chemicals, the strategy-critical activities include R&D, product innovation, getting new products onto the market quickly, effective marketing, and expertise in assisting customers. It is important for management to build its organization structure around proficient performance of these activities, making them the centerpieces or main building blocks on the organization chart.

The rationale for making strategy-critical activities the main building blocks in structuring a business is compelling: If activities crucial to strategic success are to have the resources, decision-making influence, and organizational impact they need, they have to be centerpieces in the organizational scheme. In addition, a new or changed strategy is likely to entail new or different key activities or capabilities and therefore to require a new or different organizational structure.[9] Attempting to carry out a new strategy with an old organizational structure is usually unwise.

TYPES OF ORGANIZATIONAL STRUCTURES It is common for companies engaged in a single line of business to utilize a **departmental organizational structure** that organizes strategy-critical activities into distinct *functional*, *product*, *geographic*, *process*, or *customer* groups. For instance, a technical instruments manufacturer may be organized around research and development, engineering, supply chain management, assembly, quality control, marketing technical services, and corporate administration. A company with operations scattered across a large geographic area or many countries may organize activities and reporting relationships by geography. Many diversified companies utilize a **divisional organizational structure.** A divisional structure is appropriate for a diversified building materials company that designs, produces, and markets cabinets, plumbing fixtures, windows, and paints and stains. The divisional structure organizes all of the value chain activities involved with making each type of home construction product available to

[9] The importance of matching organization design and structure to the particular needs of strategy was first brought to the forefront in a landmark study of 70 large corporations conducted by Professor Alfred Chandler of Harvard University. Chandler's research revealed that changes in an organization's strategy bring about new administrative problems that, in turn, require a new or refashioned structure for the new strategy to be successfully implemented. He found that structure tends to follow the growth strategy of the firm—but often not until inefficiency and internal operating problems provoke a structural adjustment. The experiences of these firms followed a consistent sequential pattern: new strategy creation, emergence of new administrative problems, a decline in profitability and performance, a shift to a more appropriate organizational structure, and then recovery to more profitable levels and improved strategy execution. See Alfred Chandler, *Strategy and Structure* (Cambridge, MA: MIT Press, 1962).

home builders and do-it-yourselfers into a common division and makes each division an independent profit center. **Matrixo rganizationals tructures**al low companies to specify dual reporting relationships for various value-creating building blocks. For example, in the diversified building materials company just mentioned, a matrix structure could require the marketing department for the plumbing fixtures division to report to both the corporate marketing department and the chief manager of the plumbing equipment division.

ORGANIZATIONAL STRUCTURE AND AUTHORITY IN DECISION MAKING Responsibility for results of decisions made throughout the organization ultimately lies with managers at the top of the organizational structure, but in practice, lower-level managers might possess a great deal of authority in decision making. Companies vary in the degree of authority delegated to managers of each organization unit and how much decision-making latitude given to individual employees in performing their jobs. The two extremes are to *centralize decision making* at the top (the CEO and a few close lieutenants) or to *decentralize decision making* by giving managers and employees considerable decision-making latitude in their areas of responsibility. The two approaches are based on sharply different underlying principles and beliefs, with each having its pros and cons. *In a highly decentralized organization, decision-making authority is pushed down to the lowest organizational level capable of making timely, informed, competent decisions.* The objective is to put adequate decision-making authority in the hands of the people closest to and most familiar with the situation and train them to weigh all the factors and exercise good judgment. Decentralized decision making means that the managers of each organizational unit are delegated lead responsibility for deciding how best to execute strategy.

The case for empowering down-the-line managers and employees to make decisions related to daily operations and executing the strategy is based on the belief that a company that draws on the combined intellectual capital of all its employees can outperform a command-and-control company.[10] Decentralized decision making means, for example, employees with customer contact may be empowered to do what it takes to please customers. At Starbucks, for example, employees are encouraged to exercise initiative in promoting customer satisfaction—there's the story of a store employee who, when the computerized cash register system went offline, enthusiastically offered free coffee to waiting customers.

The ultimate goal of decentralized decision making is to put decision-making authority in the hands of those persons or teams closest and most knowledgeable about the situation.

Pushing decision-making authority deep down into the organization structure and empowering employees presents its own organizing challenge: *how to exercise adequate control over the actions of empowered employees so that the business is not put at risk at the same time that the benefits of empowerment are realized.* Maintaining adequate organizational control over empowered employees is generally accomplished by placing limits on the authority that

[10] The importance of empowering workers in executing strategy and the value of creating a great working environment are discussed in Stanley E. Fawcett, Gary K. Rhoads, and Phillip Burnah, "People as the Bridge to Competitiveness: Benchmarking the 'ABCs' of an Empowered Workforce," *Benchmarking: An International Journal* 11, no. 4 (2004), pp. 346–360.

empowered personnel can exercise, holding people accountable for their decisions, instituting compensation incentives that reward people for doing their jobs in a manner that contributes to good company performance, and creating a corporate culture where there's strong peer pressure on individuals to act responsibly.

In a highly centralized organization structure, top executives retain authority for most strategic and operating decisions and keep a tight rein on business-unit heads, department heads, and the managers of key operating units; comparatively little discretionary authority is granted to frontline supervisors and rank-and-file employees. The command-and-control paradigm of centralized structures is based on the underlying assumption that frontline personnel have neither the time nor the inclination to direct and properly control the work they are performing, and that they lack the knowledge and judgment to make wise decisions about how best to do it.

The big advantage of an authoritarian structure is that it is easy to know who is accountable when things do not go well. But there are some serious disadvantages. Hierarchical command-and-control structures make an organization sluggish in responding to changing conditions because of the time it takes for the review/approval process to run up all the layers of the management bureaucracy. Also, centralized decision making is often impractical—the larger the company and the more scattered its operations, the more that decision-making authority has to be delegated to managers closer to the scene of the action.

Allocating Resources to Strategy-Critical Activities

Early in the process of implementing and executing a new or different strategy, top management must determine what funding is needed to execute new strategic initiatives, to bolster value-creating processes, and to strengthen the company's capabilities and competencies. This includes careful screening of requests for more people and new facilities and equipment, approving those that hold promise for making a contribution to strategy execution, and turning down those that don't. Should internal cash flows prove insufficient to fund the planned strategic initiatives, then management must raise additional funds through borrowing or selling additional shares of stock to willing investors.

A company's ability to marshal the resources needed to support new strategic initiatives has a major impact on the strategy execution process. Too little funding slows progress and impedes the efforts of organizational units to execute their pieces of the strategic plan proficiently. Too much funding wastes organizational resources and reduces financial performance. Both outcomes argue for managers to be deeply involved in reviewing budget proposals and directing the proper amounts of resources to strategy critical organization units.

A change in strategy nearly always calls for budget reallocations and resource shifting. Previously important units having a lesser role in the new strategy may need downsizing. Units that now have a bigger strategic role may need more people, new equipment, additional facilities, and above-average increases in their operating budgets. Strategy implementers have to exercise their power to put enough resources behind new strategic initiatives to make things happen, and they have to make the tough decisions to kill projects and activities that are no longer justified. Honda's strong support of R&D activities allowed it to develop the first low-polluting four-stroke outboard marine engine, a wide range of ultralow emission cars, the first hybrid car (Honda Insight) in the U.S. market, and the first hydrogen fuel cell car (Honda Clarity). However, Honda managers had no trouble stopping production of the Insight in 2006 when its sales failed to take off and then shifting resources to the development and manufacture of other promising hybrid models, including a totally redesigned Insight that was launched in the United States in 2009.

A company's strategic priorities must drive how capital allocations are made and the size of each unit's operating budgets.

InstitutingS trategy-Supportive Policies and Procedures

A company's policies and procedures can either assist or become a barrier to good strategy execution. Anytime a company makes changes to its business strategy, managers are well advised to carefully review existing policies and procedures and revise or discard those that are out of sync. Well-conceived policies and operating procedures act to facilitate organizational change and good strategy execution in three ways:

Well-conceived policies and procedures aid strategy execution; out-of-sync ones are barriers to effective implementation.

1. *Instituting policies and procedures provides top-down guidance regarding how certain things now need to be done.* Asking people to alter established habits and procedures, of course, always upsets the internal order of things. It is normal for pockets of resistance to develop and for people to exhibit some degree of stress and anxiety about how the changes will affect them. Policies are a particularly useful way to counteract tendencies for some people to resist change—most people refrain from violating company policy or going against recommended practices and procedures without first gaining clearance or having strong justification.
2. *Policies and procedures help enforce needed consistency in how particular strategy critical activities are performed.* Standardization and strict conformity are sometimes desirable components of good strategy execution. Eliminating significant differences in the operating practices of different plants, sales regions, or customer service centers helps a company deliver consistent product quality and service to customers.
3. *Well-conceived policies and procedures promote a work climate that facilitates good strategy execution.* Managers can use the policy-changing process as a powerful lever for changing the corporate culture in ways that produce a stronger fit with the new strategy.

McDonald's policy manual spells out detailed procedures that personnel in each McDonald's unit are expected to observe to ensure consistent quality across its 31,000 units. For example, "Cooks must turn, never flip, hamburgers.

If they haven't been purchased, Big Macs must be discarded in 10 minutes after being cooked and French fries in 7 minutes." To get store personnel to dedicate themselves to outstanding customer service, Nordstrom has a policy of promoting only those people whose personnel records contain evidence of "heroic acts" to please customers—especially customers who may have made "unreasonable requests" that require special efforts.

One of the big policy-making issues concerns what activities need to be rigidly prescribed and what activities allow room for independent action on the part of empowered personnel. Few companies need thick policy manuals to prescribe exactly how daily operations are to be conducted. Too much policy can be confusing and erect obstacles to good strategy implementation. There is wisdom in a middle approach: *Prescribe enough policies to place boundaries on employees' actions; then empower them to act within these boundaries in whatever way they think makes sense.* Allowing company personnel to act anywhere between the "white lines" is especially appropriate when individual creativity and initiative are more essential to good strategy execution than standardization and strict conformity.

Striving for Continuous Improvement in Internal Processes

Company managers can significantly advance the cause of superior strategy execution by pushing organization units and company personnel to strive for continuous improvement in how value chain activities are performed. One of the most widely used and effective tools for improving the performance of internal processes entails benchmarking the company's performance of value chain activities against "best-in-industry" and "best-in-world" performers.[11] It can also be useful to look at "best-in-company" performers of an activity if a company has a number of different organizational units performing much the same function at different locations. Identifying, analyzing, and understanding how top companies or individuals perform particular *best practices* provides useful yardsticks for judging the effectiveness and efficiency of internal operations and setting performance standards for organization units to meet or beat.

In striving for operating excellence, many companies have also come to rely on three other potent management tools: business process reengineering, total quality management (TQM) programs, and Six Sigma quality control techniques. *Business process reengineering* involves pulling the pieces of strategy-critical activities out of different departments and unifying their performance

[11] For a discussion of the value of benchmarking in implementing strategy, see Christopher E. Bogan and Michael J. English, *Benchmarking for Best Practices: Winning through Innovative Adaptation* (New York: McGraw-Hill, 1994), Chapters 2 and 6; Mustafa Ungan, "Factors Affecting the Adoption of Manufacturing Best Practices," *Benchmarking: An International Journal* 11, no. 5 (2004), pp. 504–520; Paul Hyland and Ron Beckett, "Learning to Compete: The Value of Internal Benchmarking," *Benchmarking: An International Journal* 9, no. 3 (2002), pp. 293–304; and Yoshinobu Ohinata, "Benchmarking: The Japanese Experience," *Long-Range Planning* 27, no. 4 (August 1994), pp. 48–53.

in a single department or cross-functional work group.[12] When done properly, business process reengineering can produce dramatic operating benefits. In the order-processing section of General Electric's circuit breaker division, elapsed time from order receipt to delivery was cut from three weeks to three days by consolidating six production units into one, reducing a variety of former inventory and handling steps, automating the design system to replace a human custom-design process, and cutting the organizational layers between managers and workers from three to one. Productivity rose 20 percent in one year, and unit manufacturing costs dropped 30 percent.[13]

Total quality management (TQM) is a philosophy of managing a set of business practices that emphasizes continuous improvement in all phases of operations, 100 percent accuracy in performing tasks, involvement and empowerment of employees at all levels, team-based work design, benchmarking, and total customer satisfaction.[14] While TQM concentrates on the production of quality goods and fully satisfying customer expectations, it achieves its biggest successes when it is extended to employee efforts in *all departments*—human resources, billing, R&D, engineering, accounting and records, and information systems. It involves reforming the corporate culture and shifting to a total quality/continuous improvement business philosophy that permeates every facet of the organization.[15] TQM doctrine preaches that there's no such thing as "good enough" and that everyone has a responsibility to participate in continuous improvement. TQM is thus a race without a finish. Success comes from making little steps forward each day, a process that the Japanese call *kaizen.*

Six Sigma quality control consists of a disciplined, statistics-based system aimed at producing not more than 3.4 defects per million iterations for any business process—from manufacturing to customer transactions.[16] The Six Sigma process of define, measure, analyze, improve, and control (DMAIC, pronounced *Dee-may-ic*) is an improvement system for existing processes

[12] Michael Hammer and James Champy, *Reengineering the Corporation* (New York: HarperBusiness, 1993) pp. 26–27.

[13] Gene Hall, Jim Rosenthal, and Judy Wade, "How to Make Reengineering Really Work," *Harvard Business Review* 71, no. 6 (November–December 1993), pp. 119–131.

[14] For some of the seminal discussions regarding what TQM is and how it works, see M. Walton, *The Deming Management Method* (New York: Pedigree, 1986); J. Juran, *Juran on Quality by Design* (New York: Free Press, 1992); Philip Crosby, *Quality Is Free: The Act of Making Quality Certain* (New York: McGraw-Hill, 1979); and S. George, *The Baldrige Quality System* (New York: Wiley, 1992). For a critique of TQM, see Mark J. Zbaracki, "The Rhetoric and Reality of Total Quality Management," *Administrative Science Quarterly* 43, no. 3 (September 1998), pp. 602–636.

[15] For a discussion of the shift in work environment and culture that TQM entails, see Robert T. Amsden, Thomas W. Ferratt, and Davida M. Amsden, "TQM: Core Paradigm Changes," *Business Horizons* 39, no. 6 (November–December 1996), pp. 6–14.

[16] For easy to understand overviews of what Six Sigma is all about, see Peter S. Pande and Larry Holpp, *What Is Six Sigma?* (New York: McGraw-Hill, 2002); Jiju Antony, "Some Pros and Cons of Six Sigma: An Academic Perspective," *The TQM Magazine* 16, no. 4 (2004), pp. 303–306; Peter S. Pande, Robert P. Neuman, and Roland R. Cavanagh, *The Six Sigma Way: How GE, Motorola and Other Top Companies Are Honing Their Performance* (New York: McGraw-Hill, 2000); and Joseph Gordon and M. Joseph Gordon, Jr., *Six Sigma Quality for Business and Manufacture* (New York: Elsevier, 2002). For how Six Sigma can be used in smaller companies, see Godecke Wessel and Peter Burcher, "Six Sigma for Small and Medium-sized Enterprises," *The TQM Magazine* 16, no. 4 (2004), pp. 264–272.

falling below specification. The Six Sigma DMADV (define, measure, analyze, design, and verify) methodology is used to develop *new* processes or products at Six Sigma quality levels.[17] DMADV is sometimes referred to as Design for Six Sigma (DFSS). The statistical thinking underlying Six Sigma is based on the following three principles: All work is a process, all processes have variability, and all processes create data that explain variability.[18] To illustrate how these three principles work, consider the case of a Milwaukee hospital that used Six Sigma to map the prescription-filling process. Prescriptions written in the hospital originated with a doctor's write-up, were filled by the hospital pharmacy, and then administered by nurses. DMAIC analysis revealed that most mistakes came from misreading the doctor's handwriting.[19] The hospital implemented a program requiring doctors to type the prescription into a computer, which slashed the number of errors dramatically.

While Six Sigma programs often improve the efficiency of many operating activities and processes, there is evidence that innovation can be stifled by Six Sigma programs. The essence of Six Sigma is to reduce variability in processes, but creative processes, by nature, include quite a bit of variability. In many instances, breakthrough innovations occur only after thousands of ideas have been abandoned and promising ideas have gone through multiple iterations and extensive prototyping. Google CEO Eric Schmidt has commented that the innovation process is "anti–Six Sigma" and applying Six Sigma principles to those performing creative work at Google would choke off innovation at the company.[20]

James McNerney, a GE executive and proponent of Six Sigma, became CEO at 3M Corporation and was unable to establish a long-term track record for innovation following his institution of Six Sigma-based principles at 3M. 3M's researchers complained that the innovation process did not lend itself well to the extensive data collection and analysis required under Six Sigma and that too much time was spent completing reports that outlined the market potential and possible manufacturing concerns for projects in all stages of the R&D pipeline. Six Sigma rigidity and a freeze on 3M's R&D budget from McNerney's first year as CEO through 2005 was blamed for the company's drop from number one to number seven on the Boston Consulting Group's list of Most Innovative Companies.[21]

A blended approach to Six Sigma implementation that is gaining in popularity pursues incremental improvements in operating efficiency, while R&D and other processes that allow the company to develop new ways of offering value to customers are given more free rein. Managers of these *ambidextrous organizations* are adept at employing continuous improvement in operating processes but allowing R&D to operate under a set of rules that allows for the development of breakthrough innovations. Ciba Vision, a global leader in contact lenses, has dramatically reduced operating expenses through the use of

[17] Based on information posted at www.sixsigma.com, November 4, 2002.
[18] Kennedy Smith, "Six Sigma for the Service Sector," *Quality Digest Magazine*, May 2003, www.qualitydigest.com, accessed September 28, 2003.
[19] Del Jones, "Taking the Six Sigma Approach," *USA Today*, October 31, 2002, p. 5B.
[20] As quoted in "A Dark Art No More," *The Economist* 385, no. 8550 (October 13, 2007), p. 10.
[21] Brian Hindo, "At 3M, a Struggle between Efficiency and Creativity," *BusinessWeek*, June 11, 2007, pp. 8–16.

continuous improvement programs, while simultaneously and harmoniously developing new series of contact lens products that have grown its revenues by 300 percent over a 10-year period.[22]

The Difference between Business Process Reengineering and Continuous Improvement Programs like Six Sigma and TQM

Business process reengineering and continuous improvement efforts like TQM and Six Sigma both aim at improved efficiency, better product quality, and greater customer satisfaction. The essential difference between business process reengineering and continuous improvement programs is that reengineering aims at *quantum gains* on the order of 30 to 50 percent or more whereas total quality programs stress *incremental progress*—striving for inch-by-inch gains again and again in a never-ending stream. The two approaches to improved performance of value chain activities and operating excellence are not mutually exclusive; it makes sense to use them in tandem. Reengineering can be used first to produce a good basic design that yields quick, dramatic improvements in performing a business process. Total quality programs can then be used as a follow-up to deliver continuing improvements.

> The purpose of using benchmarking, best practices, business process reengineering, TQM, Six Sigma, or other operational improvement programs is to improve the performance of strategy-critical activities and promote superior strategy execution.

Installing Information and Operating Systems

Company strategies and value-creating internal processes can't be executed well without a number of internal operating systems. FedEx has internal communication systems that allow it to coordinate its 80,000-plus vehicles in handling an average of 7.5 million packages a day. Its leading-edge flight operations systems allow a single controller to direct as many as 200 of FedEx's 650 aircraft simultaneously, overriding their flight plans should weather or other special emergencies arise. In addition, FedEx has created a series of e-business tools for customers that allow them to ship and track packages online, review shipping history, generate custom reports, simplify customer billing, reduce internal warehousing and inventory management costs, and purchase goods and services from suppliers. All of FedEx's systems support the company's strategy of providing businesses and individuals with a broad array of package delivery services (from premium next-day to economical five-day deliveries) and boosting its competitiveness against United Parcel Service, DHL, and the U.S. Postal Service.

Telephone companies have elaborate information systems to measure signal quality, connection times, interrupts, wrong connections, billing errors, and other measures of reliability that affect customer service and satisfaction. British Petroleum (BP) has outfitted rail cars carrying hazardous materials

[22] For a discussion of approaches to pursuing radical or disruptive innovations while also seeking incremental gains in efficiency, see Charles A. O'Reilly and Michael L. Tushman, "The Ambidextrous Organization," *Harvard Business Review* 82, no. 4 (April 2004), pp. 74–81.

with sensors and global-positioning systems (GPS) so that it can track the status, location, and other information about these shipments via satellite and relay the data to its corporate intranet. At eBay, there are systems for real-time monitoring of new listings, bidding activity, Web site traffic, and page views.

Information systems need to cover five broad areas: (1) customer data, (2) operations data, (3) employee data, (4) supplier/partner/collaborative ally data, and (5) financial performance data. All key strategic performance indicators have to be tracked and reported as often as practical. Long the norm, monthly profit-and-loss statements and monthly statistical summaries are fast being replaced with daily statistical updates and even up-to-the-minute performance monitoring. Many retail companies have automated online systems that generate daily sales reports for each store and maintain up-to-the-minute inventory and sales records on each item. Manufacturing plants typically generate daily production reports and track labor productivity on every shift. Many retailers and manufacturers have online data systems connecting them with their suppliers that monitor the status of inventories, track shipments and deliveries, and measure defect rates. Regardless of the industry, real-time information systems permit company managers to stay on top of implementation initiatives and daily operations, and to intervene if things seem to be drifting off course.

> Having good information systems and operating data is integral to competent strategy execution and operating excellence.

Using Rewards and Incentives to Promote Better Strategy Execution

To create a strategy supportive system of rewards and incentives, a company must emphasize rewarding people for accomplishing results related to creating value for customers, not for just dutifully performing assigned tasks. Focusing jobholders' attention and energy on what to *achieve* as opposed to what to *do* makes the work environment results-oriented. It is flawed management to tie incentives and rewards to satisfactory performance of duties and activities instead of desired business outcomes and company achievements.[23] In any job, performing assigned tasks is not equivalent to achieving intended outcomes. Diligently showing up for work and attending to job assignment does not, by itself, guarantee results. As any student knows, the fact that an instructor teaches and students go to class doesn't necessarily mean that the students are learning.

> A properly designed reward structure is management's most powerful tool for gaining employee commitment to superior strategy execution and excellent operating results.

Motivationan dR ewardS ystems

It is important for both organization units and individuals to be properly aligned with strategic priorities and enthusiastically committed to executing strategy. *To get employees' sustained, energetic commitment, management has to be resourceful*

[23] See Steven Kerr, "On the Folly of Rewarding A while Hoping for B," *Academy of Management Executive* 9, no. 1 (February 1995), pp. 7–14; Steven Kerr, "Risky Business: The New Pay Game," *Fortune*, July 22, 1996, pp. 93–96; and Doran Twer, "Linking Pay to Business Objectives," *Journal of Business Strategy* 15, no. 4 (July–August 1994), pp. 15–18.

in designing and using motivational incentives—both monetary and nonmonetary. The more a manager understands what motivates subordinates and is able to use appropriate motivational incentives, the greater will be employees' commitment to good day-in, day-out strategy execution and achievement of performance targets.[24]

Guidelines for Designing Monetary Incentive Systems

Guidelines for creating incentive compensation systems that link employee behavior to organizational objectives include:

1. *Make the performance payoff a major, not minor, piece of the total compensation package.* The payoff for high-performing individuals and teams must be meaningfully greater than the payoff for average performers, and the payoff for average performers meaningfully bigger than for below-average performers.
2. *Have incentives that extend to all managers and all workers, not just top management.* Lower-level managers and employees are just as likely as senior executives to be motivated by the possibility of lucrative rewards.
3. *Administer the reward system with scrupulous objectivity and fairness.*I f performance standards are set unrealistically high or if individual/group performance evaluations are not accurate and well documented, dissatisfaction with the system will overcome any positive benefits.
4. *Tie incentives to performance outcomes directly linked to good strategy execution and financial performance.* Incentives should never be paid just because people are thought to be "doing a good job" or because they "work hard." An argument can be made that exceptions should be made in giving rewards to people who've come up short because of circumstances beyond their control. The problem with making exceptions for unknowable, uncontrollable, or unforeseeable circumstances is that once good excuses start to creep into justifying rewards for subpar results, the door is open for all kinds of reasons why actual performance has failed to match targeted performance.
5. *Make sure that the performance targets each individual or team is expected to achieve involve outcomes that the individual or team can personally affect.*T he role of incentives is to enhance individual commitment and channel behavior in beneficial directions.
6. *Keep the time between achieving the target performance outcome and the payment of the reward as short as possible.* Companies like Nucor and Continental Airlines have discovered that weekly or monthly payments for good performance work much better than annual payments. Nucor pays weekly bonuses based on prior-week production levels; Continental awards employees a monthly bonus for each month that on-time flight performance meets or beats a specified percentage companywide. Annual

[24] The importance of motivating and empowering workers to create a working environment that is highly conducive to good strategy execution is discussed in Fawcett, Rhoads, and Burnah, "People as the Bridge to Competitiveness: Benchmarking the 'ABCs' of an Empowered Workforce."

bonus payouts work best for higher-level managers and for situations where target outcome relates to overall company profitability or stock price performance.

Once the incentives are designed, they have to be communicated and explained. Everybody needs to understand how their incentive compensation is calculated and how individual/group performance targets contribute to organizational performance targets.

NonmonetaryR ewards

Financial incentives generally head the list of motivating tools for trying to gain whole-hearted employee commitment to good strategy execution and operating excellence. But most successful companies also make extensive use of nonmonetary incentives. Some of the most important nonmonetary approaches used to enhance motivation are listed below:[25]

- *Provide attractive perks and fringe benefits*—The various options include full coverage of health insurance premiums; college tuition reimbursement; paid vacation time; on-site child care; on-site fitness centers; casual dress every day; telecommuting; and compressed workweeks (four 10-hour days instead of five 8-hour days).
- *Adopt promotion from within policies*—This practice helps bind workers to their employers and employers to their workers, plus, it is an incentive for good performance.
- *Act on suggestions from employees*—Research indicates that the moves of many companies to push decision making down the line and empower employees increases employee motivation and satisfaction, as well as boostingp roductivity.
- *Create a work atmosphere in which there is genuine sincerity, caring, and mutual respect among workers and between management and employees*—A"f amily" work environment where people are on a first-name basis and there is strong camaraderie promotes teamwork and cross-unit collaboration.
- *Share information with employees about financial performance, strategy, operational measures, market conditions, and competitors' actions*—Broadd isclosure and prompt communication send the message that managers trust their workers.
- *Have attractive office spaces and facilities*—A workplace environment with appealing features and amenities usually has decidedly positive effects on employee morale and productivity.

Concepts & Connections 10.1 presents specific examples of the motivational tactics employed by several prominent companies that have appeared on *Fortune*'s list of "The 100 Best Companies to Work for in America."

[25] Jeffrey Pfeffer and John F. Veiga, "Putting People First for Organizational Success," *Academy of Management Executive* 13, no. 2 (May 1999), pp. 37–45; Linda K. Stroh and Paula M. Caliguiri, "Increasing Global Competitiveness through Effective People Management," *Journal of World Business* 33, no. 1 (Spring 1998), pp. 1–16; and articles in *Fortune* on the 100 best companies to work for (various issues).

Concepts & Connections 10.1

WHAT COMPANIES DO TO MOTIVATE AND REWARD EMPLOYEES

Companies have come up with an impressive variety of motivational and reward practices to help create a work environment that energizes employees and promotes better strategy execution. Here's a sampling of what companies are doing:

- Lincoln Electric, widely known for its piecework pay scheme and incentive bonus plan, rewards individual productivity by paying workers for each nondefective piece produced. Workers have to correct quality problems on their own time—defects in products used by customers can be traced back to the worker who caused them. Lincoln's piecework plan motivates workers to pay attention to both quality and volume produced. In addition, the company sets aside a substantial portion of its profits above a specified base for worker bonuses. To determine bonus size, Lincoln Electric rates each worker on four equally important performance measures: dependability, quality, output, and ideas and cooperation. The higher a worker's merit rating, the higher the incentive bonus earned; the highest-rated workers in good profit years receive bonuses of as much as 110 percent of their piecework compensation.
- Wegmans, a family-owned grocer with 71 stores on the East Coast of the United States provides employees with flexible schedules and benefits that include on-site fitness centers. The company's approach to managing people allows it to provide a very high level of customer service not found in other grocery chains. Employees ranging from cashiers, to butchers, to store managers are all treated equally and viewed as experts in their jobs. Employees' skills are enhanced through 50 hours of formal training per year and employees are allowed to make decisions that they believe are appropriate for their jobs. The company's annual turnover rate is only 6 percent, which is less than one-half the 14 percent average turnover rate in the U.S. supermarket industry.
- Nordstrom, highly regarded for its superior in-house customer service experience, typically pays its retail salespeople an hourly wage higher than the prevailing rates paid by other department store chains plus a commission on each sale. Spurred by a culture that encourages salespeople to go all-out to satisfy customers and to seek out and promote new fashion ideas, Nordstrom salespeople often earn twice the average incomes of sales employees at competing stores. The typical Nordstrom sales person earns nearly $38,000 per year and sales department managers earn, on average, $48,500 per year. Nordstrom's rules for employees are simple: "Rule #1: Use your good judgment in all situations. There will be no additional rules."
- At W. L. Gore (the maker of Gore-Tex), employees get to choose what project/team they work on and each team member's compensation is based on other team members' rankings of his or her contribution to the enterprise.
- At biotech leader Amgen, employees get 16 paid holidays, generous vacation time, tuition reimbursements up to $10,000, on-site massages, a discounted car-wash, and the convenience of shopping at on-site farmers' markets.

Sources: *Fortune*'s lists of the 100 best companies to work for in America, 2002, 2004, 2005, and 2008; and Jefferson Graham, "The Search Engine That Could," *USA Today*, August 26, 2003, p. B3.

Corporate Cultures and Superior Strategy Execution

Every company has its own unique culture. The character of a company's culture or work climate is a product of the work practices and behaviors that define "how we do things around here," its approach to people management, and the "chemistry" that permeates its work environment. The meshing together of stated core values, beliefs, business principles, style of operating, ingrained behaviors and attitudes, and work climate define a company's

corporate culture. A company's culture is important because it influences the organization's actions and approaches to conducting business—in a very real sense, the culture is the company's organizational DNA.[26]

Corporate culture is a company's internal work climate and is shaped by its core values, beliefs, business principles, traditions, work practices, and style of operating.

The psyche of corporate cultures varies widely. For instance, the bedrock of Walmart's culture is dedication to customer satisfaction, zealous pursuit of low costs and frugal operating practices, a strong work ethic, ritualistic Saturday-morning headquarters meetings to exchange ideas and review problems, and company executives' commitment to visiting stores, listening to customers, and soliciting suggestions from employees. General Electric's culture is founded on a hard-driving, results-oriented atmosphere (where all of the company's business divisions are held to a standard of being number one or two in their industries as well as achieving good business results); extensive cross-business sharing of ideas, best practices, and learning; the reliance on "workout sessions" to identify, debate, and resolve burning issues; a commitment to Six Sigma quality; and globalization of the company.

UnhealthyC orporateC ultures

The distinctive characteristic of an unhealthy corporate culture is the presence of counterproductive cultural traits that adversely impact the work climate and company performance.[27] The following four traits are particularly unhealthy:

1. A highly politicized internal environment in which many issues get resolved and decisions are made on the basis of which individuals or groups have the most political clout.
2. Hostility to change and a general wariness of people who champion new ways of doing things.
3. An insular "not-invented-here" mindset that makes company personnel averse to looking outside the company for best practices, new managerial approaches, and innovative ideas.
4. A disregard for high ethical standards and an overzealous pursuit of wealth and status on the part of key executives.

POLITICIZED CULTURES What makes a politicized internal environment so unhealthy is that political infighting consumes a great deal of organizational energy and often results in the company's strategic agenda taking a backseat to political maneuvering. In companies where internal politics pervades the work climate, empire-building managers pursue their own agendas and the positions they take on issues are usually aimed at protecting or expanding their turf. The support or opposition of politically influential executives and/or coalitions among departments with vested interests in a particular outcome typically weighs heavily in deciding what actions the company

[26] Joanne Reid and Victoria Hubbell, "Creating a Performance Culture," *Ivey Business Journal* 69, no. 4 (March/April 2005), p. 1.
[27] John P. Kotter and James L. Heskett, *Corporate Culture and Performance* (New York: Free Press, 1992), Chapter 6.

takes. All this maneuvering takes away from efforts to execute strategy with real proficiency and frustrates company personnel who are less political and more inclined to do what is in the company's best interests.

CHANGE-RESISTANT CULTURES Change-resistant cultures encourage a number of undesirable or unhealthy behaviors—avoiding risks, hesitation in pursuing emerging opportunities, and widespread aversion to continuous improvement in performing value chain activities. Change-resistant companies have little appetite for being first-movers or fast-followers, believing that being in the forefront of change is too risky and that acting too quickly increases vulnerability to costly mistakes. They are more inclined to adopt a wait-and-see posture, learn from the missteps of early-movers, and then move forward cautiously with initiatives that are deemed safe. Hostility to change is most often found in companies with multilayered management bureaucracies that have enjoyed considerable market success in years past and that are wedded to the "We have done it this way for years" syndrome.

General Motors, IBM, Sears, and Eastman Kodak are classic examples of companies whose change-resistant bureaucracies have damaged their market standings and financial performance; clinging to what made them successful, they were reluctant to alter operating practices and modify their business approaches when signals of market change first sounded. As strategies of gradual change won out over bold innovation, all four lost market share to rivals that quickly moved to institute changes more in tune with evolving market conditions and buyer preferences. While IBM has made strides in building a culture needed for market success, Sears, GM, and Kodak are still struggling to recoup lost ground.

INSULAR, INWARDLY FOCUSED CULTURES Sometimes a company reigns as an industry leader or enjoys great market success for so long that its personnel start to believe they have all the answers or can develop them on their own. Such confidence breeds arrogance—company personnel discount the merits of what outsiders are doing and what can be learned by studying best-in-class performers. Benchmarking and a search for the best practices of outsiders are seen as offering little payoff. The big risk of a must-be-invented-here mindset and insular cultural thinking is that the company can underestimate the competencies and accomplishments of rival companies and overestimate its own progress—with a resulting loss of competitive advantage over time.

UNETHICAL AND GREED-DRIVEN CULTURES Companies that have little regard for ethical standards or that are run by executives driven by greed and ego gratification are scandals waiting to happen. Enron's collapse in 2001 was largely the product of an ethically dysfunctional corporate culture—while Enron's culture embraced the positives of product innovation, aggressive risk taking, and a driving ambition to lead global change in the energy business, its executives exuded the negatives of arrogance, ego, greed, and an "ends-justify-the-means" mentality in pursuing stretch revenue and profitability targets.[28] A number of Enron's senior managers were all too

[28] See Kurt Eichenwald, *Conspiracy of Fools: A True Story* (New York: Broadway Books, 2005).

willing to wink at unethical behavior, to cross over the line to unethical (and sometimes criminal) behavior themselves, and to deliberately stretch generally accepted accounting principles to make Enron's financial performance look far better than it really was. In the end, Enron came unglued because a few top executives chose unethical and illegal paths to pursue corporate revenue and profitability targets. Unethical cultures and executive greed have produced scandals at WorldCom, Quest, HealthSouth, Adelphia, Tyco, Cendant, Parmalat, KPMG, AIG, Marsh & McLennan, Countrywide Financial, and Stanford Financial Group with executives indicted and/or convicted of criminal behavior.

High-Performance Cultures

Some companies have so-called "high-performance" cultures where the standout cultural traits are a "can-do" spirit, pride in doing things right, no-excuses accountability, and a pervasive results-oriented work climate where people go the extra mile to meet or beat stretch objectives. In high-performance cultures, there's a strong sense of involvement on the part of company personnel and emphasis on individual initiative and creativity. Performance expectations are clearly stated for the company as a whole, for each organizational unit, and for each individual. Issues and problems are promptly addressed—there's a razor-sharp focus on what needs to be done. A high-performance culture where there's constructive pressure to achieve good results is a valuable contributor to good strategy execution and operating excellence. Results-oriented cultures are permeated with a spirit of achievement and have a good track record in meeting or beating performance targets.[29]

The challenge in creating a high-performance culture is to inspire high loyalty and dedication on the part of employees, such that they are energized to put forth their very best efforts to do things right. Managers have to take pains to reinforce constructive behavior, reward top performers, and purge habits and behaviors that stand in the way of good results. They must work at knowing the strengths and weaknesses of their subordinates, so as to better match talent with task. In sum, there has to be an overall disciplined, performance-focused approach to managing the organization.[30]

AdaptiveC ultures

The hallmark of adaptive corporate cultures is willingness on the part of organizational members to accept change and take on the challenge of introducing and executing new strategies.[31] In direct contrast to change-resistant cultures, **adaptive cultures** are very supportive of managers and employees at all ranks who propose or help initiate useful change. Internal entrepreneurship on the part of individuals and groups is encouraged and rewarded. Senior executives seek out, support, and promote individuals who exercise initiative,

[29] For a good discussion of how a strategy-supportive, high-performance culture can contribute to competitive advantage, see Jay B. Barney and Delwyn N. Clark, *Resource-Based Theory: Creating and Sustaining Competitive Advantage* (New York: Oxford University Press, 2007), chapter 4.

[30] Reid and Hubbell, "Creating a Performance Culture," pp. 2 and 5.

[31] This section draws heavily on the discussion of Kotter and Heskett, *Corporate Culture and Performance*, Chapter 4.

spot opportunities for improvement, and display the skills to take advantage of them. As in high-performance cultures, the company exhibits a proactive approach to identifying issues, evaluating the implications and options, and quickly moving ahead with workable solutions.

Adaptive cultures are exceptionally well-suited to companies competing in fast-changing market environments.

Technology companies, software companies, and Internet-based companies are good illustrations of organizations with adaptive cultures. Such companies thrive on change—driving it, leading it, and capitalizing on it (but sometimes also succumbing to change when they make the wrong move or are swamped by better technologies or the superior business models of rivals). Companies like Google, Intel, Cisco Systems, eBay, Apple, Amazon.com, and Dell cultivate the capability to act and react rapidly. They are avid practitioners of entrepreneurship and innovation, with a demonstrated willingness to take bold risks to create altogether new products, new businesses, and new industries. To create and nurture a culture that can adapt rapidly to changing or shifting business conditions, they make a point of staffing their organizations with people who are proactive, who rise to the challenge of change, and who have an aptitude for adapting.

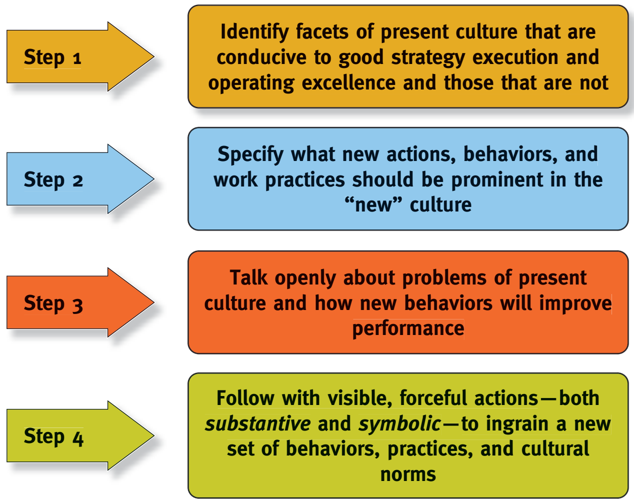
In fast-changing business environments, a corporate culture that is receptive to altering organizational practices and behaviors is a virtual necessity. However, adaptive cultures work to the advantage of all companies, not just those in rapid-change environments. Every company operates in a market and business climate that is changing to one degree or another. *As a company's strategy evolves, an adaptive culture is a definite ally in the strategy-implementing, strategy-executing process as compared to cultures that have to be coaxed and cajoled to change.*

Changing a Problem Culture

Changing a company culture that impedes proficient strategy execution is among the toughest management tasks. It is natural for company personnel to cling to familiar practices and to be wary, if not hostile, to new approaches toward how things are to be done. Consequently, it takes concerted management action over a period of time to root out certain unwanted behaviors and replace an out-of-sync culture with more effective ways of doing things. *The single most visible factor that distinguishes successful culture-change efforts from failed attempts is competent leadership at the top.* Great power is needed to force major cultural change and overcome the unremitting resistance of entrenched cultures—and great power is possessed only by the most senior executives, especially the CEO. However, while top management must be out front leading the culture change effort, instilling new cultural behaviors is a job for the whole management team. Middle managers and frontline supervisors play a key role in implementing the new work practices and operating approaches, helping win rank-and-file acceptance of and support for the changes, and instilling the desired behavioral norms.

As shown in Figure 10.2, the first step in fixing a problem culture is for top management to identify those facets of the present culture that pose obstacles to executing new strategic initiatives. Second, managers have to clearly define the desired new behaviors and features of the culture they want to create.

FIGURE 10.2 Steps in Changing a Problem Culture



Third, managers have to convince company personnel why the present culture poses problems and why and how new behaviors and operating approaches will improve company performance. Finally, all the talk about remodeling the present culture has to be followed swiftly by visible, forceful actions on the part of management to promote the desired new behaviors and work practices.

MAKING A COMPELLING CASE FOR A CULTURE CHANGE The place for management to begin a major remodeling of the corporate culture is by selling company personnel on the need for new-style behaviors and work practices. This means making a compelling case for why the company's new strategic direction and culture-remodeling efforts are in the organization's best interests and why company personnel should whole-heartedly join the effort to do things somewhat differently. This can be done by:

- Citing reasons why the current strategy has to be modified and why new strategic initiatives are being undertaken. The case for altering the old strategy usually needs to be predicated on its shortcomings—why sales are growing slowly, why too many customers are opting to go with the products of rivals, why costs are too high, and so on. There may be merit in holding events where managers and other key personnel are forced to listen to dissatisfied customers or the complaints of strategic allies.
- Citing why and how certain behavioral norms and work practices in the current culture pose obstacles to good execution of new strategic initiatives.
- Explaining why new behaviors and work practices have important roles in the new culture and will produce better results.

Management's efforts to make a persuasive case for changing what is deemed to be a problem culture must be *quickly followed* by forceful, high-profile actions across several fronts. The actions to implant the new culture must be both substantive and symbolic.

SUBSTANTIVE CULTURE-CHANGING ACTIONS No culture change effort can get very far when leaders merely talk about the need for different actions, behaviors, and work practices. Company executives have to give the culture-change effort some teeth by initiating *a series of actions* that company personnel will see as *unmistakable support* for the change program. The strongest signs that management is truly committed to instilling a new culture include:

1. Replacing key executives who stonewall needed organizational and culturalc hanges.
2. Promoting individuals who have stepped forward to advocate the shift to a different culture and who can serve as role models for the desired culturalb ehavior.
3. Appointing outsiders with the desired cultural attributes to high-profile positions—bringing in new-breed managers sends an unambiguous message that a new era is dawning.
4. Screening all candidates for new positions carefully, hiring only those who appear to fit in with the new culture.
5. Mandating that all company personnel attend culture-training programs to better understand the culture-related actions and behaviors that are expected.
6. Designing compensation incentives that boost the pay of teams and individuals who display the desired cultural behaviors, while hitting change-resisters in the pocketbook.
7. Revising policies and procedures in ways that will help drive cultural change.

SYMBOLIC CULTURE-CHANGING ACTIONS There's also an important place for symbolic managerial actions to alter a problem culture and tighten the strategy–culture fit. The most important symbolic actions are those that top executives take to *lead by example.* For instance, if the organization's strategy involves a drive to become the industry's low-cost producer, senior managers must display frugality in their own actions and decisions: inexpensive decorations in the executive suite, conservative expense accounts and entertainment allowances, a lean staff in the corporate office, few executive perks, and so on. At Walmart, all the executive offices are simply decorated; executives are habitually frugal in their own actions, and they are zealous in their own efforts to control costs and promote greater efficiency. At Nucor, one of the world's low-cost producers of steel products, executives fly coach class and use taxis at airports rather than limousines. Top executives must be alert to the fact that company personnel will be watching their actions and decisions to see if they are walking the talk.[32]

Another category of symbolic actions includes holding ceremonial events to single out and honor people whose actions and performance exemplify what is called for in the new culture. A point is made of holding events to celebrate

[32] Judy D. Olian and Sara L. Rynes, "Making Total Quality Work: Aligning Organizational Processes, Performance Measures, and Stakeholders," *Human Resource Management* 30, no. 3 (Fall 1991), p. 324.

each culture-change success. Executives sensitive to their role in promoting the strategy–culture fit make a habit of appearing at ceremonial functions to praise individuals and groups that get with the program. They show up at employee training programs to stress strategic priorities, values, ethical principles, and cultural norms. Every group gathering is seen as an opportunity to repeat and ingrain values, praise good deeds, and cite instances of how the new work practices and operating approaches have led to improved results.

Leading the Strategy-Execution Process

Leading the strategy-execution process requires senior managers to be out in the field, seeing for themselves how well operations are going and gauging the progress being made. Company managers need to be diligent and adept in ferreting out problems and issues, learning what obstacles lie in the path of operating excellence, and then clearing the way for progress—the goal must be to get to better results speedily and productively. And there has to be constructive, but unrelenting, pressure on organizational units to (1) demonstrate growing consistency in strategy execution and (2) achieve performance targets—ultimately, it's all about producing excellent strategy execution and financial results.

There comes a time at every company when managers have to fine-tune or overhaul the approaches to strategy execution and push for better results. Clearly, when a company's strategy execution effort is not delivering good results and making measurable progress toward operating excellence, it is the leader's responsibility to step forward and push corrective actions. Success in initiating corrective actions usually hinges on thorough analysis of the situation, the exercise of good business judgment in deciding what actions to take, and good implementation of the corrective actions that are initiated. Successful managers are skilled in getting an organization back on track rather quickly. Managers that struggle to show measurable progress in generating good results and improving the performance of strategy-critical value chain activities are candidates for being replaced.

The challenges of leading a successful strategy execution effort are, without question, substantial.[33] But the job is definitely doable. Because each instance of executing strategy occurs under different organizational circumstances, the managerial agenda for executing strategy always needs to be situation-specific—there's no neat generic procedure to follow. And as we said at the beginning of the chapter, executing strategy is an action-oriented, make-the-right-things-happen task that challenges a manager's ability to lead and direct organizational change, create or reinvent business processes, manage and motivate people, and achieve performance targets.

[33] For a good discussion of the challenges, see Daniel Goleman, "What Makes a Leader," *Harvard Business Review* 76, no. 6 (November–December 1998), pp. 92–102; Ronald A. Heifetz and Donald L. Laurie. "The Work of Leadership," *Harvard Business Review* 75, no. 1 (January–February 1997), pp. 124–134; and Charles M. Farkas and Suzy Wetlaufer, "The Ways Chief Executive Officers Lead," *Harvard Business Review* 74, no. 3 (May–June 1996), pp. 110–122. See also, Michael E. Porter, Jay W. Lorsch, and Nitin Nohria, "Seven Surprises for New CEOs," *Harvard Business Review* 82, no. 10 (October 2004), pp. 62–72.

KeyP oints

Implementing and executing strategy is an operation-driven activity revolving around the management of people and business processes. The managerial emphasis is on converting strategic plans into actions and good results. *Management's handling of the process of implementing and executing the chosen strategy can be considered successful if and when the company achieves the targeted strategic and financial performance and shows good progress in making its strategic vision a reality.*

Like crafting strategy, executing strategy is a job for a company's whole management team, not just a few senior managers. Top-level managers have to rely on the active support and cooperation of middle and lower managers to push strategy changes into functional areas and operating units and to see that the organization actually operates in accordance with the strategy on a daily basis.

Eight managerial tasks crop up repeatedly in company efforts to execute strategy:

1. *Building an organization capable of executing the strategy successfully.*B uild- ing an organization capable of good strategy execution entails three types of organization-building actions: (1) s*taffing the organization*—assembling a talented, can-do management team, and recruiting and retaining employees with the needed experience, technical skills, and intellectual capital, (2) *building dynamic capabilities and core competencies* that will enable good strategy execution and updating them as strategy and external conditions change, and (3) s*tructuring the organization and work effort*—organizing value chain activities and business processes and deciding how much decision-making authority to push down to lower-level managers and frontline employees.
2. *Allocating ample resources to strategy-critical activities.* Managers implementing and executing a new or different strategy must identify the resource requirements of each new strategic initiative and then consider whether the current pattern of resource allocation and the budgets of the various subunits are suitable.
3. *Ensuring that policies and procedures facilitate rather than impede effective strategy execution.* Anytime a company alters its strategy, managers should review existing policies and operating procedures, proactively revise or discard those that are out of sync, and formulate new ones to facilitate execution of new strategic initiatives.
4. *Pushing for continuous improvement in how value chain activities are performed.* Benchmarking, the discovery and adoption of best practices, reengineering core business processes, and continuous improvement initiatives like total quality management (TQM) or Six Sigma programs all aim at improved efficiency, lower costs, better product quality, and greater customer satisfaction.
5. *Installing information and operating systems that enable company personnel to perform essential activities.* Well-conceived state-of-the-art support systems not only facilitate better strategy execution but also strengthen organizational capabilities enough to provide a competitive edge over rivals.
6. *Tying rewards directly to the achievement of performance objectives.* For an incentive compensation system to work well (1) the monetary payoff should be a major piece of the compensation package, (2) the use of incentives should extend to all managers and workers, (3) the system should be administered with care and fairness, (4) the incentives should be linked to performance targets spelled out in the strategic plan, (5) each individual's performance targets should involve outcomes the person can personally affect, (6) rewards should promptly follow the determination of good performance, and (7) monetary rewards should be supplemented with liberal use of nonmonetary rewards.

7. *Fostering a corporate culture that promotes good strategy execution.* The psyche of corporate cultures varies widely. There are four types of unhealthy cultures: (1) those that are highly political and characterized by empire-building, (2) those that are change resistant, (3) those that are insular and inwardly focused, and (4) those that are ethically unprincipled and are driven by greed. High-performance cultures and adaptive cultures both have positive features that are conducive to good strategy execution.
8. *Exerting the internal leadership needed to propel implementation forward.* Leading the drive for good strategy execution and operating excellence calls for three actions on the part of the manager-in-charge: (1) staying on top of what is happening, closely monitoring progress, and learning what obstacles lie in the path of good execution; (2) putting constructive pressure on the organization to achieve good results and operating excellence; and (3) pushing corrective actions to improve strategy execution and achieve the targeted results.

Assurance of Learning Exercises

1. Read some of the recent Six Sigma articles posted at isixsigma.com. Prepare a one-page report to your instructor detailing how Six Sigma is being used in various companies and what benefits these companies are reaping from Six Sigma implementation. **LO4**
2. Consultt hel atesti ssueo f *Fortune* containing the annual "100 Best Companies to Work For" (usually a late January or early February issue, or else go to www.fortune.com to access the list) and identify at least five compensation incentives and work practices that these companies use to enhance employee motivation and reward them for good strategic and financial performance. You should identify compensation methods and work practices that are different from those cited in Concepts & Connections 10.1. **LO6**
3. Go to the Jobs section at www.intel.com and see what Intel has to say about its culture under the links for Careers, Diversity, and The Workplace. Does what's on this Web site appear to be just recruiting propaganda, or does it convey the type of work climate that management is actually trying to create? Explain your answer. **LO7**

Exercisesf or Simulation Participants

1. How would you describe the organization of your company's top management team? Is some decision making decentralized and delegated to individual managers? If so, explain how the decentralization works. Or are decisions made more by consensus, with all co-managers having input? What do you see as the advantages and disadvantages of the decision-making approach your company ise mploying? **LO1 LO2 LO6 LO7**
2. Have you and your co-managers allocated ample resources to strategy-critical areas? If so, explain how these investments have contributed to good strategy execution and improved company performance.
3. Does your company have opportunities to use incentive compensation techniques? If so, explain your company's approach to incentive compensation. Is there any hard evidence you can cite that indicates your company's use of incentive compensation techniques has worked? For example, have your company's

compensation incentives actually boosted productivity? Can you cite evidence indicating that the productivity gains have resulted in lower labor costs? If the productivity gains have *not* translated into lower labor costs, then is it fair to say that your company's use of incentive compensation is a failure?

4. If you were making a speech to company personnel, what would you tell them about the kind of corporate culture you would like to have at your company? What specific cultural traits would you like your company to exhibit? Explain.

Appendix

Key Ratios to Assess a Company's Financial Performance

RATIO	HOW CALCULATED	WHAT IT SHOWS
Profitability Ratios		
1. Gross profit margin	$\frac{\text{Sales} - \text{Cost of goods sold}}{\text{Sales}}$	Shows the percent of revenues available to cover operating expenses and yield a profit. Higher is better and the trend should be upward.
2. Operating profit margin (or return on sales)	$\frac{\text{Sales} - \text{Operating expenses}}{\text{Sales}}$ or $\frac{\text{Operating income}}{\text{Sales}}$	Shows the profitability of current operations without regard to interest charges and income taxes. Higher is better and the trend should be upward.
3. Net profit margin (or net return on sales)	$\frac{\text{Profits after taxes}}{\text{Sales}}$	Shows after tax profits per dollar of sales. Higher is better and the trend should be upward.
4. Return on total assets	$\frac{\text{Profits after taxes} + \text{interest}}{\text{Total assets}}$	A measure of the return on total investment in the enterprise. Interest is added to after tax profits to form the numerator since total assets are financed by creditors as well as by stockholders. Higher is better and the trend should be upward.
5. Return on stockholder's equity	$\frac{\text{Profits after taxes}}{\text{Total stockholders' equity}}$	Shows the return stockholders are earning on their investment in the enterprise. A return in the 12–15% range is "average", and the trend should be upward.
7. Earnings per share	$\frac{\text{Profits after taxes}}{\text{Number of shares of common stock outstanding}}$	Shows the earnings for each share of common stock outstanding. The trend should be upward, and the bigger the annual percentage gains, the better.
Liquidity Ratios		
1. Current ratio	$\frac{\text{Current assets}}{\text{Current liabilities}}$	Shows a firm's ability to pay current liabilities using assets that can be converted to cash in the near term. Ratio should definitely be higher than 1.0; ratios of 2 or higher are better still.
2. Quick ratio (or acid-test ratio)	$\frac{\text{Current assets} - \text{Inventory}}{\text{Current liabilities}}$	Shows a firm's ability to pay current liabilities without relying on the sale of its inventories.
3. Working capital	Current assets − current liabilities	Bigger amounts are better because the company has more internal funds available to (1) pay its current liabilities on a timely basis and (2) finance inventory expansion, additional accounts receivable, and a larger base of operations without resorting to borrowing or raising more equity capital.

Key Ratios to Assess a Company's Financial Performance (continued)

RATIO	HOW CALCULATED	WHAT IT SHOWS
Leverage Ratios		
1. Debt-to-assets ratio	$\frac{\text{Total debt}}{\text{Total assets}}$	Measures the extent to which borrowed funds have been used to finance the firm's operations. Low fractions or ratios are better—high fractions indicate overuse of debt and greater risk of bankruptcy.
2. Debt-to-equity ratio	$\frac{\text{Total debt}}{\text{Total stockholders' equity}}$	Should usually be less than 1.0. High ratios (especially above 1.0) signal excessive debt, lower creditworthiness, and weaker balance sheet strength.
3. Long-term debt-to-equity ratio	$\frac{\text{Long-term debt}}{\text{Total stockholders' equity}}$	Shows the balance between debt and equity in the firm's *long-term* capital structure. Low ratios indicate greater capacity to borrow additional funds if needed.
4. Times-interest-earned (or coverage) ratio	$\frac{\text{Operating income}}{\text{Interest expenses}}$	Measures the ability to pay annual interest charges. Lenders usually insist on a minimum ratio of 2.0, but ratios above 3.0 signal better creditworthiness.
Activity Ratios		
1. Days of inventory	$\frac{\text{Inventory}}{\text{Cost of goods sold} \div 365}$	Measures inventory management efficiency. Fewer days of inventory are usually better.
2. Inventory turnover	$\frac{\text{Cost of goods sold}}{\text{Inventory}}$	Measures the number of inventory turns per year. Higher is better.
3. Average collection period	$\frac{\text{Accounts receivable}}{\text{Total sales} \div 365}$ or $\frac{\text{Accounts receivable}}{\text{Average daily sales}}$	Indicates the average length of time the firm must wait after making a sale to receive cash payment. A shorter collection time is better.
Other Important Measures of Financial Performance		
1. Dividend yield on common stock	$\frac{\text{Annual dividends per share}}{\text{Current market price per share}}$	A measure of the return to owners received in the form of dividends.
2. Price-earnings ratio	$\frac{\text{Current market price per share}}{\text{Earnings per share}}$	P-e ratios above 20 indicate strong investor confidence in a firm's outlook and earnings growth; firms whose future earnings are at risk or likely to grow slowly typically have ratios below 12.
3. Dividend payout ratio	$\frac{\text{Annual dividends per share}}{\text{Earnings per share}}$	Indicates the percentage of after-tax profits paid out as dividends.
4. Internal cash flow	After tax profits + Depreciation	A quick and rough estimate of the cash a company's business is generating after payment of operating expenses, interest, and taxes. Such amounts can be used for dividend payments or funding capital expenditures.
5. Free cash flow	After tax profits + Depreciation − Capital Expenditures − Dividends	A quick and rough estimate of the cash a company's business is generating after payment of operating expenses, interest, and taxes, dividends, and necessary reinvestments in the business. Such amounts can be used to fund additional capital expenditures, acquisitions, share repurchase plans, higher dividend payments, or new strategic initiatives.

Case 1

Mystic Monk Coffee

DavidL. Turnipseed
Universityo fSo uthAl abama

As Father Daniel Mary, the Prior of the Carmelite Order of monks in Clark, Wyoming, walked to chapel to preside over Mass, he noticed the sun glistening across the four-inch snowfall from the previous evening. Snow in June was not unheard of in Wyoming, but the late 2009 snowfall and the bright glow of the rising sun made him consider the opposing forces accompanying change and how he might best prepare his monastery to achieve his vision of creating a new Mount Carmel in the Rocky Mountains. His vision of transforming the small brotherhood of 13 monks living in a small home used as makeshift rectory into a 500-acre monastery that would include accommodations for 30 monks, a Gothic church, a convent for Carmelite nuns, a retreat center for lay visitors, and a hermitage presented a formidable challenge. However, as a former high-school football player, boxer, bull rider, and man of great faith, Father Prior Daniel Mary was unaccustomed to shrinking from a challenge.

Father Prior had identified a nearby ranch for sale that met the requirements of his vision perfectly, but its current listing price of $8.9 million presented a financial obstacle to creating a place of prayer, worship, and solitude in the Rockies. The Carmelites had received a $250,000 donation that could be used toward the purchase and the monastery had earned nearly $75,000 during the first year of its Mystic Monk Coffee operations, but more money would be needed. The coffee roaster used to produce packaged coffee sold to Catholic consumers at the Mystic Monk Coffee Web site was reaching its capacity, but a larger roaster could be purchased for $35,000. Also, local Cody, Wyoming, business owners had begun a foundation for those wishing to donate to the monks' cause. Father Prior Daniel Mary did not have a great deal of experience in business matters, but he considered to what extent the monastery could rely on its Mystic Monk Coffee operations to fund the purchase of the ranch. If Mystic Monk Coffee was capable of making the vision a reality, what were the next steps in turning the coffee intol and?

The Carmelite Monks of Wyoming

Carmelites are a religious order of the Catholic Church that was formed by men who came to the Holy Land as pilgrims and crusaders and had chosen to remain near Jerusalem to seek God. The men established their hermitage at Mount Carmel because of its beauty, seclusion, and Biblical importance as the site where Elijah stood against King Ahab and the false prophets of Jezebel to prove Jehovah to be the one true God. The Carmelites led a life of solitude, silence, and prayer at Mount Carmel before eventually returning to Europe and becoming a recognized order of the Catholic Church. The size of the Carmelite Order varied widely throughout the centuries with its peak coming in the 1600s and stood at approximately 2,200 friars living on all inhabited continents at the beginning of the 21st Century.

The Wyoming Carmelite monastery was founded in 2003 by Father Daniel Mary who lived as a Carmelite hermit in Minnesota before moving to Clark, Wyoming, to establish the new monastery. The Wyoming Carmelites were a cloistered order and were allowed to leave the monastery only by permission of the bishop for medical needs or the death of a family member. The Wyoming monastery abbey bore little resemblance to the great stone cathedrals and monasteries of Europe and was confined to a rectory that had once been a ranch-style four-bedroom home and an adjoining 42 acres of land that had been donated to the monastery in 2007.

There were 13 monks dedicated to a life of prayer and worship in the Wyoming Carmelite monastery in 2009. Since the founding of the monastery in 2003, there had been more than 500 inquiries from young men considering becoming a Wyoming Carmelite. Father Prior Daniel Mary wished to eventually have 30 monks ranging from 19 to 30 years old who would live out their lives in the monastery. However, the selection criteria for acceptance into the monastery were rigorous, with the monks making certain that applicants understood the reality of the vows of obedience, chastity, and poverty and the sacrifices associated with living a cloistered religious life.

TheD aily Activities of a Carmelite Monk

Each day began at 4:10 a.m. for the Carmelite monks when they arose and went to chapel for worship wearing traditional brown habits and hand-made sandals. At about 6:00, the monks rested and contemplated in silence for one hour before Father Prior began morning Mass. After Mass, the monks went about their manual labors. In performing their labors, each brother had a special set of skills that enabled the monastery to independently maintain its operations. Brother Joseph Marie was an excellent mechanic, Brother Paul was a carpenter, Brother Peter Joseph (Brother Cook) worked in the kitchen, and 5-foot 4-inch Brother Simon Mary (Little Monk) was the secretary to Father Daniel Mary. Brother Elias, affectionately known as Brother Java, was Mystic Monk Coffee's master roaster, although he was not a coffee drinker.

The daily work performed by each monk took up to six hours per day; however, the monks' primary focus was on prayer, with eight hours of each day spent in prayer. At 11:40, the monks stopped work and went to Chapel. Afterward they had lunch, cleaned the dishes, and went back to work. At 3:00 p.m., the hour that Jesus was believed to have died on the cross, work stopped again for prayer and worship. The monks then returned to work until the bell was rung for Vespers (evening prayer) The monks then had an hour of silent contemplation, their evening meal, and more prayers.

The New Mount Carmel

Soon after arriving in Wyoming, Father Daniel Mary had formed the vision of acquiring a larger parcel of land—a new Mount Carmel—and building a monastery with accommodations for 30 monks, a retreat center for lay visitors, a Gothic church, a convent for Carmelite nuns, and a hermitage. In a letter to supporters posted on the monastery's Web site in February of 2009, Father Daniel Mary succinctly stated his vision: "We beg your prayers, your friendship and your support that this vision, our vision may come to be that Mount Carmel may be refounded in Wyoming's Rockies for the glory of God." The brothers located a 496-acre ranch that was offered for sale that would satisfy all of the requirements to create a new Mount Carmel. The Irma Lake Ranch was located outside Cody, Wyoming, and included a 17,800-square-foot remodeled residence, a 1,700-square-foot caretaker house, a 2,950-square-foot guesthouse, a hunting cabin, dairy and horse barn, and forested land for those wishing to live as hermits.

Lake Irma Ranch was at the end of a seven-mile private gravel road, about 21 miles outside of town, and was bordered on one side by the private Hoodoo Ranch (100,000 acres) and on the other by the Shoshone National Park (2.4 million acres). Although the price of the ranch was $8.9 million, the monks believed they would be able to acquire the property through donations and the profits generated by the monastery's Mystic Monk Coffee (MMC) operations. The monastery had received a donation of $250,000 from an individual wishing to support the Carmelites that could be applied toward whatever purpose the monks chose. Additionally, a group of Cody business owners had formed the New Mount Carmel Foundation to help the monks raise funds.

Overviewo f the Coffee Industry

About 150 million consumers in the United States drank coffee with 89 percent of U.S. coffee drinkers brewing their own coffee at home rather than purchasing ready-to-drink coffee at coffee shops and restaurants such as Starbucks, Dunkin Donuts, or McDonald's. Packaged coffee used to brew coffee at home was easy to find in any grocery store and typically carried a retail price of $4–$6 for a 12-ounce package in 2009. About 30 million coffee drinkers in the United States preferred premium-quality specialty coffees that sold for $7–$10 per 12-ounce package in 2009. Specialty coffees were made from higher quality Arabica beans instead of the mix of lower quality Arabica beans and bitter and less flavorful Robusta coffee beans that was used by the makers of value brands. The wholesale price of Robusta coffee beans averaged $1.15 per pound in July 2008, while mild Colombian Arabica wholesale prices averaged $1.43 per pound.

Prior to the 1990s, the market for premium-quality specialty coffees barely existed in the United States, but Howard Schultz's vision for Starbucks of bringing the Italian espresso bar experience to America helped specialty coffees account for approximately 20 percent of coffee industry sales by 2008. The company's pursuit of its mission "To inspire and nurture the human spirit—one person, one cup, and one neighborhood at a time" had allowed Starbucks' revenues to increase from $465 million in 1995 to nearly $10.4 billion in 2008. The company's rapid growth had given rise to a number of competing specialty coffee shops and premium brands of packaged specialty coffee, including Seattle's Best, Millstone, Green Mountain Coffee Roasters, and First Colony Coffee and Tea. Some producers such as First Colony had difficulty gaining shelf space in supermarkets and concentrated on private-label roasting and packaging for fine department stores and other retailers wishing to have a proprietary brand of coffee.

Specialty coffees sold under premium brands might be made from shade grown or organically grown coffee beans or have been purchased from a grower belonging to a World Fair Trade Organization (WFTO) cooperative. WFTO cooperative growers were paid above market prices to better support the cost of operating their farms—for example, WFTO certified organic wholesale prices averaged $1.55 per pound in July 2008. Many consumers who purchased specialty coffees were willing to pay a higher price for organic, shade grown, or fair trade coffee because of their personal health or social concerns—organic coffees were grown without the use of synthetic fertilizers or pesticides, shade grown coffee plants were allowed to grow beneath the canopies of larger indigenous trees, and fair trade pricing made it easier for farmers in developing countries to pay workers a living wage. In 2007, the retail sales of organic coffee accounted for about $1 billion of the $13.5 billion specialty coffee market in the United States and had grown at an annual rate of 32 percent between 2000 and 2007.

Mystic Monk Coffee

Mystic Monk Coffee was produced using high quality fair trade Arabica and fair trade organic Arabica beans. The monks produced whole bean and ground caffeinated and decaffeinated varieties in dark, medium, or light roast and in different flavors. The most popular Mystic Monk flavors were Mystical Chants of Carmel, Cowboy Blend, Royal Rum Pecan, and Mystic Monk Blend. All varieties of Mystic Monk Coffee were sold via the monastery's Web site (www.mysticmonkcoffee.com) in 12-ounce bags at a price of $9.95 with the exception of sample bags, which carried a retail price of $2.99. All purchases from the MMC Web site were delivered by UPS or the United States Postal Service. Frequent customers were given the option of joining a "coffee club" which offered monthly delivery of 1 to 6 bags of preselected coffee. Purchases of 3 bags or more were shipped to MMC customers free of charge. MMC also sold T-shirts, gift cards, CDs featuring the monastery's Gregorian chants, and coffee mugs at its Web site.

Mystic Monk Coffee's target market was the segment of the U.S. Catholic population who drank coffee and wished to support the monastery's mission. In 2009, more than 69 million Americans were members of the Catholic Church—making it four times larger than the second largest Christian denomination in the United States. An appeal to Catholics "*to use their catholic coffee dollar for Christ and his Catholic church*" was published on the Mystic Monk Coffee Web site.

MysticM onkC offee Roasting Operations

After the morning religious services and breakfast, Brother Java roasted the green coffee beans delivered each week from a coffee broker in Seattle, Washington. The monks paid the Seattle broker the prevailing wholesale price per pound, which fluctuated daily with global supply and demand. The capacity of MMC's roaster limited production to 540 pounds per day although production was also limited by time devoted to prayer, silent meditation, and worship. As of 2009, demand for Mystic Monk Coffee had not exceeded the roaster's capacity, but the monastery planned to purchase a larger 130-pound per hour roaster when demand further approached its capacity. The monks had received a quote of $35,000 for the new larger roaster.

Marketing and Web Site Operations

Mystic Monk Coffee was promoted primarily by word of mouth among loyal customers in Catholic parishes across the United States. The majority of MMC's sales were made through its Web site, but on occasion, telephone orders were placed with its secretary who worked outside the cloistered part of the monastery. Mystic Monk Coffee also offered secular Web site operators commissions on its sales through its Mystic Monk Coffee Affiliate Program that placed banner ads and text ads on participating Web sites. Affiliate sites earned an 18 percent commission on sales made to customers who were directed to www.mysticmonkcoffee.com from their site. The affiliate program's ShareASale participation level allowed affiliates to refer new affiliates to MMC and earn 56 percent of the new affiliate's commission. The monks expanded MMC's business model to include wholesale sales to churches and local coffee shops in mid-2009.

Mystic Monk's Financial Performance

At the conclusion of MMC's first year in operation (fiscal 2008), its sales of coffee and coffee accessories averaged about $56,500 per month. Its cost of sales averaged about 30 percent of revenues, inbound shipping costs accounted for 19 percent of revenues, and broker fees were 3 percent of revenues for a total cost of goods sold of 52 percent. Operating expenses such as utilities, supplies, telephone, and Web site maintenance averaged 37 percent of revenues. Its net profit margin during fiscal 2008 averaged 11 percent of revenues.

Realizing the Vision

During a welcome period of solitude before his evening meal, Father Prior again contemplated the purchase of Lake Irma Ranch. He realized that his vision of purchasing the ranch would require careful planning and execution. For the Wyoming Carmelites, coffee sales were a means of support from the outside world that might provide the financial resources to purchase the land. Father Prior understood that the cloistered monastic environment offered unique challenges to operating a business enterprise, but also provided opportunities that were not available to secular businesses. He resolved to develop an execution plan that would enable Mystic Monk Coffee to minimize the effect of its cloistered monastic constraints, maximize the potential of monastic opportunities, and realize his vision of buying the Irma Lake ranch.

Case 2

Whole Foods Market in 2008: Vision, Core Values, and Strategy

Arthur A. Thompson
The University of Alabama

Founded in 1980, Whole Foods Market evolved from a local supermarket for natural and health foods in Austin, Texas, into the world's largest retail chain of natural and organic foods supermarkets. The company had 2007 sales of $6.6 billion and in early 2008 had 276 stores in the United States, Canada, and Great Britain. Revenues had grown at a compound annual rate of 30 percent since 1991 and 20 percent since 2000. Management's near-term growth objectives for Whole Foods were to have 400 stores and sales of $12 billion in fiscal year 2010.

During its 27-year history, Whole Foods Market had been a leader in the natural and organic foods movement across the United States, helping the industry gain acceptance among growing numbers of consumers concerned about the food they ate. The company sought to offer the highest quality, least processed, most flavorful and naturally preserved foods available. John Mackey, the company's cofounder and CEO, believed that Whole Foods' rapid growth and market success had much to do with its having "remained a uniquely mission-driven company—highly selective about what we sell, dedicated to our core values and stringent quality standards and committed to sustainable agriculture."

Mackey's vision was for Whole Foods to become an international brand synonymous not just with natural and organic foods but also with being the best food retailer in every community in which Whole Foods stores were located. He wanted Whole Foods Market to set the standard for excellence in food retailing. Mackey's philosophy was that marketing high-quality natural and organic foods to more and more customers in more and more communities would over time gradually transform the diets of individuals in a manner that would help them live longer, healthier, more pleasurable lives. But as the company's motto, "Whole Foods, Whole People, Whole Planet," implied, its core mission extended well beyond food retailing—see Exhibit 1. At its Web site, the company proclaimed that its deepest purpose as an organization was helping support the health, well-being, and healing of both people—customers, team members, and business organizations in general—and the planet.[1]

The Natural And Organic Foods Industry

The combined sales of foods and beverages labeled as "natural" or organic—about $62 billion in 2007—represented about 7.3 percent of the roughly $850 billion in total U.S. grocery store sales. *Natural foods* are defined as foods that are minimally processed; largely or completely free of artificial ingredients, preservatives, and other non–naturally occurring chemicals; and as near to their whole, natural state as possible.

Exhibit 1

Whole Foods Market's Motto: Whole Foods, Whole People, Whole Planet

Whole Foods

We obtain our products locally and from all over the world, often from small, uniquely dedicated food artisans. We strive to offer the highest quality, least processed, most flavorful and naturally preserved foods. We believe that food in its purest state—unadulterated by artificial additives, sweeteners, colorings, and preservatives—is the best tasting and most nutritious food available.

Whole People

We recruit the best people we can to become part of our team. We empower them to make many operational decisions, creating a respectful workplace where team members are treated fairly and are highly motivated to succeed. We look for team members who are passionate about food, but also well-rounded human beings who can play a critical role in helping build our Company into a profitable and beneficial part of every community in which we operate.

Whole Planet

We believe companies, like individuals, must assume their share of responsibility for our planet. We actively support organic farming on a global basis because we believe it is the best method for promoting sustainable agriculture and protecting the environment and farm workers. On a local basis, we are actively involved in our communities by supporting food banks, sponsoring neighborhood events, and contributing at least 5 percent of our after-tax profits in the form of cash or products to not-for-profit organizations.

Source: Company overview, posted at www.wholefoodsmarket.com (accessed March 21, 2008), and 2007 10-K report, p. 5.

The U.S. Department of Agriculture's Food and Safety Inspection Service defines *natural food* as "a product containing no artificial ingredient or added color and that is minimally processed." While sales of natural foods products had increased at double-digit rates in the 1990s, growth had slowed to the 7–9 percent range since 2000.

Organic foods were a special subset of the natural foods category; to be labeled as organic, foods had to be grown and processed without the use of pesticides, antibiotics, hormones, synthetic chemicals, artificial fertilizers, preservatives, dyes or additives, or genetic engineering. Organic foods included fresh fruits and vegetables, meats, and processed foods that had been produced using any or all of the following:

- Agricultural management practices that promoted a healthy and renewable ecosystem. These practices could include no genetically engineered seeds or crops, petroleum-based fertilizers, fertilizers made from sewage sludge, synthetic pesticides, herbicides, or fungicides.
- Livestock management practices that involved organically grown feed, fresh air and outdoor access for the animals, and no use of antibiotics or growth hormones.
- Food processing practices that protected the integrity of the organic product and did not involve the use of radiation, genetically modified organisms, or synthetic preservatives.

In 1990, passage of the Organic Food Production Act started the process of establishing national standards for organically grown products in the United States, a movement that included farmers, food activists, conventional food producers, and consumer groups. In October 2002, the U.S. Department of Agriculture (USDA) officially established labeling standards for organic products, overriding both the patchwork of inconsistent state regulations for what could be labeled as organic and the different rules of some 43 agencies for certifying organic products. The new USDA regulations established four categories of food with organic ingredients, with varying levels of organic purity:

1. *100 percent organic products:* Such products were usually whole foods, such as fresh fruits and vegetables, grown by

organic methods—which meant that the product had been grown without the use of synthetic pesticides or sewage-based fertilizers; had not been subjected to irradiation; and had not been genetically modified or injected with bioengineered organisms, growth hormones, or antibiotics. Products that were 100 percent organic could carry the green USDA organic certification seal, provided the merchant could document that the food product had been organically grown (usually by a certified organicp roducer).

2. *Organic products:* Such products, often processed, had to have at least 95 percent organically certified ingredients. These could also carry the green USDA organic certifications eal.
3. *Made with organic ingredients:* Such products had to have at least 70 percent organic ingredients; they could be labeled "made with organic ingredients" but could not display the USDA seal.
4. *All other products with organic ingredients:* Products with less than 70 percent organic ingredients could not use the word *organic* on the front of a package, but organic ingredients could be listed among other ingredients in a less prominent part of the package.

An official with the National Organic Program, commenting on the appropriateness and need for the new USDA regulations, said, "For the first time, when consumers see the word *organic* on a package, it will have consistent meaning."[2] The new labeling program was not intended as a health or safety program (organic products have not been shown to be more nutritious than conventionally grown products, according to the American Dietetic Association), but rather as a marketing solution. An organic label had long been a selling point for shoppers wanting to avoid pesticides or to support environmentally friendly agricultural practices. However, the new regulations required documentation on the part of growers, processors, exporters, importers, shippers, and merchants to verify that they were certified to grow, process, or handle organic products carrying the USDA's organic seal. In 2003, Whole Foods was designated as the first national "Certified Organic" grocer by Quality Assurance International, a federally recognized independent third-party certification organization.

According to the Organic Consumers Association, sales of organic foods in the United States hit $17 billion in 2006, up 22 percent from $13.8 billion in 2005. When natural foods and beverages (defined narrowly as those with no artificial ingredients) were lumped in with organic foods and beverages, the U.S. retail sales total came to $28.2 billion in 2006, up from $23.0 billion in 2005. Natural and organic foods and beverages were projected to reach nearly $33 billion in 2008. Organic food sales were said to represent about 3 percent of total U.S. retail sales of food and beverages. About 31 percent of overall organic sales in 2006 were through mainstream supermarkets/grocery stores, and 24 percent were through the leading natural food supermarket chains such as Whole Foods, Wild Oats, and Trader Joe's. Another 22 percent of all organic sales were through independent, small natural grocery store chains. Organic foods and beverages were available in nearly every food category in 2008 and were available in over 75 percent of U.S. retail food stores. Most observers believed that organic products had staying power in the marketplace as opposed to being a passing fad.

Major food processing companies like Kraft, General Mills, Groupe Danone (the parent of Dannon Yogurt), Dean Foods, and Kellogg had all purchased organic food producers in an effort to capitalize on growing consumer interest in purchasing organic foods. Heinz had introduced an organic ketchup and bought a 19 percent stake in Hain Celestial Group, one of the largest organic and natural foods producers. Campbell Soup had introduced organic tomato juice. Starbucks, Green Mountain Coffee, and several other premium coffee marketers were marketing organically grown coffees; Coca-Cola's Odwalla juices were organic; Del Monte and Hunt's were marketing organic canned tomatoes; and Tyson Foods and several other chicken producers had introduced organic chicken products. Producers of organically grown beef were selling all they could produce, and sales were expected to grow 30 percent annually through 2008.

Organic farmland in the United States totaled 4.1 million acres (about 1.7 million acres of cropland and 2.4 million acres of rangeland and pasture) in 2005, up from 2.1 million acres in 2001.[3] There were 8,400 certified organic farms in 2005, and perhaps another 9,000 small farmers growing organic products. All 50 states had some certified organic farmland, with California, North Dakota, Montana, Minnesota, Wisconsin, Texas, and Idaho having the largest amount of certified organic cropland. While only about 1 percent of U.S. farmland was certified organic in 2005, farmers were becoming increasingly interested in and attracted to organic farming, chiefly because of the substantially higher prices they could get for organically grown fruits, vegetables, and meats.

Retailing Of Organic Foods

According to the USDA, 2000 was the first year in which more organic food was sold in conventional U.S. supermarkets than in the nation's 14,500 natural foods stores. Since 2002, most mainstream supermarkets had been expanding their selections of natural and organic products, which ranged from fresh produce to wines, cereals, pastas, cheeses, yogurts, vinegars, potato chips, beef, chicken, and canned and frozen fruits and vegetables. Fresh produce was the most popular organic product—lettuce, broccoli, cauliflower, celery, carrots, and apples were the biggest sellers. Meat, dairy, bread, and snack foods were among the fastest-growing organic product categories. Most supermarket chains stocked a selection of natural and organic food items, and the number and variety of items they carried was growing. Leading supermarket chains like Walmart, Kroger, Publix, Safeway, and Supervalu/Save-a-Lot had created special "organic and health food" sections for nonperishable items in most of their stores. Kroger, Publix, and several other chains also had special sections for fresh organic fruits and vegetables in their produce cases in most of their stores in 2007. Safeway, Publix, and Kroger were stocking organic beef and chicken in a number of their stores, while Whole Foods was struggling to find organic beef and chicken suppliers big enough to supply all its stores. Two chains—upscale Harris Teeter in the southeastern United States and Whole Foods Market—had launched their own private-label brands of organics. Exhibit 2 shows the leading supermarket retailers in North America in 2006. Whole Foods Market was ranked 24th in 2006, up from 26th in 2004.

Most industry observers expected that, as demand for organic foods increased, conventional supermarkets would continue to expand their offerings and selection. Supermarkets were attracted to merchandising organic foods for several reasons: Consumer demand for organic foods was growing at close to 20 percent annually, and mounting consumer enthusiasm for organic products allowed retailers to command attractively high profit margins on organic products. In contrast, retail sales of general food products were growing slowly (in part because more and more consumers were eating out rather than cooking at home) and price competition among rival supermarket chains was intense (which dampened profit margins on many grocery items).

Several factors had combined to transform organic foods retailing, once a niche market, into the fastest-growing segment of U.S. food sales:

- Healthier eating patterns on the part of a populace that was becoming better educated about foods, nutrition, and good eating habits. Among those most interested in organic products were aging, affluent people concerned about health and better-for-youf oods.
- Increasing consumer concerns over the purity and safety of food due to the presence of pesticide residues, growth hormones, artificial ingredients, chemicals, and genetically engineered ingredients.

Exhibit 2

Leading North American Supermarket Chains, 2006

RANK/COMPANY	NUMBER OF STORES	2006 SALES REVENUES (IN BILLIONS)	SHARE OF TOTAL U.S. GROCERY SALES ($850 BILLION)
1. Walmart	2,297	$209.9 [a]	9.4%
2. Kroger	2,477	66.1 [b]	7.8
3. Costco	458	59.0 [c]	4.3
4. Sam's Club	580	42.2 [d]	3.0
5. Safeway	1,767	40.5	4.8
6. Supervalu	434	37.4 [e]	4.4
7. Loblaw [f]	1,072	26.5	3.1
8. Ahold USA [g]	827	24.0	2.8
9. Publix Supermarkets	885	21.7	2.6
10. Delhaize [h]	1,544	17.3	2.0
11. Meijer	176	13.2	1.6
		. . .	
24. Whole Foods Market	188	5.6	0.7

[a] Sales revenue numbers include all store items in Walmart Discount Stores and Supercenters, not just those related to food and groceries. Sales of grocery, candy, tobacco, and health and beauty aids represented about 38 percent of total sales at Walmart Discount Stores and Supercenters. Walmart's market share percentage is based on grocery- and supermarket-item sales of $79.8 billion (38 percent of $209.9 billion).

[b] Sales data for Kroger (whose supermarket brands also include City Market, King Sooper, Ralph's, and 11 smaller chains) include revenues from all company-owned retail outlets (fuel centers, drugstores, apparel, and jewelry) that are not supermarket-related.

[c] The sales revenue figure for Costco includes all items sold at Costco stores; sales of only grocery items (food, sundries, fresh produce, gasoline, and pharmacy) were $36.6 billion; the market share percentage is based on that $36.6 billion.

[d] Sales revenue numbers include all store items sold at Sam's Club, not just those related to food and groceries; food and sundries accounted for 61 percent of sales (about $25.7 billion). The market share percentage is based on estimated food and grocery-related sales of $25.7 billion.

[e] Sales data for Supervalu includes 1,368 supermarkets (including 1,124 of which were recently acquired from Albertson's), 301 corporate-owned Save-A-Lots, 867 licensed Save-A-Lots, and 31 licensed Cub Foods stores.

[f] Loblaw is a Canadian chain; sales and market shares are based only on Loblaw store sales in the United States.

[g] Ahold USA , the U.S. division of Netherlands-based Ahold, includes 386 Stop & Shops, 192 Giant Foods (Landover, Maryland), 126 Giant Foods (Carlisle, Pennsylvania), and 123 Tops Markets.

[h] Delhaize includes 1,171 Food Lion stores, 158 Hannaford Bros. stores, 108 Sweetbay and Kash 'n Karry stores, 68 Harvey's stores, 22 Bloom units, and 17 Bottom Dollar stores.

Sources: Walmart's 2007 10-K report and "Top 75 North American Food Retailers," www.supermarketnews.com (accessed March 20, 2008).

- A "wellness," or health-consciousness, trend among people of many ages and ethnicgr oups.
- Growing belief that organic farming had positive environmental effects, particularly in contributing to healthier soil and water conditions and to sustainable agricultural practices (which was confirmed by a series of studies done at the University of Michigan and the University of Illinois).[4]

A 2005 survey commissioned by Whole Foods found that 65 percent of U.S. consumers had tried organic foods and beverages, up from 54 percent in both 2003 and 2004; 27 percent of respondents indicated they consumed more organic foods and beverages than they did one year before.[5] Ten percent consumed organic foods several times per week, up from just 7 percent in 2004. The top three reasons why consumers were buying organic foods and beverages were avoidance of pesticides (70.3 percent), freshness (68.3 percent), and health and nutrition (67.1 percent); 55 percent reported buying organic to avoid genetically modified foods. Also, many respondents agreed that organic foods and beverages were better for their health (52.8 percent) and better for the environment (52.4 percent). The categories of organic foods and beverages purchased most frequently by those participating in Whole Foods' survey were fresh fruits and vegetables

(73 percent), nondairy beverages (32 percent), bread or baked goods (32 percent), dairy items (24.6 percent), packaged goods such as soup or pasta (22.2 percent), meat (22.2 percent), snack foods (22.1 percent), frozen foods (16.6 percent), prepared and ready-to-eat meals (12.2 percent), and baby food (3.2 percent).

The higher prices of organic products were the primary barrier for most consumers in trying or using organic products—75 percent of those participating in the 2005 Whole Foods survey believed organics were too expensive. Other reasons for not consuming more organics were availability (46.1 percent) and loyalty to non-organic brands (36.7 percent).

WholeF oods Market

Whole Foods Market was founded in Austin, Texas, when John Mackey, the current CEO, and two other local natural foods grocers in Austin decided the natural foods industry was ready for a supermarket format. The original Whole Foods Market opened in 1980 with a staff of only 19. It was an immediate success. At the time, there were fewer than half a dozen natural foods supermarkets in the United States. By 1991, the company had 10 stores, revenues of $92.5 million, and net income of $1.6 million. Whole Foods became a public company in 1992, with its stock trading on the NASDAQ; Whole Foods stock was added to the Standard & Poor's Mid-Cap 400 Index in May 2002 and to the NASDAQ-100 Index in December 2002.

Core Values

In 1997, when Whole Foods developed the "Whole Foods, Whole People, Whole Planet" slogan, John Mackey, known as a go-getter with a "cowboy way of doing things," said:

> This slogan taps into perhaps the deepest purpose of Whole Foods Market. It's a purpose we seldom talk about because it seems pretentious, but a purpose nevertheless felt by many of our team members and by many of our customers (and hopefully many of our shareholders too). Our deepest purpose as an organization is helping support the health, well-being, and healing of both people (customers and Team Members) and of the planet (sustainable agriculture, organic production, and environmental sensitivity). When I peel away the onion of my personal consciousness down to its core in trying to understand what has driven me to create and grow this company, I come to my desire to promote the general well-being of everyone on earth as well as the earth itself. This is my personal greater purpose with the company and the slogan perfectly reflects it.

Complementing the slogan were five core values shared by both top management and company personnel (see Exhibit 3). In the company's 2003 annual report, John Mackey said:

> Our core values reflect the sense of collective fate among our stakeholders and are the soul of our company. Our Team Members, shareholders, vendors, community and environment must flourish together through their affiliation with us or we are not succeeding as a business. It is leadership's role to balance the needs and desires of all our stakeholders and increase the productivity of Whole Foods Market. By growing the collective pie, we create larger slices for all of our shareholders.

GrowthS trategy

Since going public in 1991, Whole Foods' growth strategy had been to expand via a combination of opening its own new stores and acquiring small, owner-managed chains that had capable personnel and were located in desirable markets—the company's most significant acquisitions are shown in Exhibit 4. But since the retailers of natural and organic foods were mostly one-store operations and small, regional chains having stores in the 5,000- to 20,000-square-foot range, attractive acquisition candidates were hard to find. From 2002 to 2006, Whole Foods' management decided to drive growth by opening 10 to 15 decidedly bigger stores in metropolitan areas each year—stores that ranged from 40,000 square feet to as much as 70,000 square feet and were on the same scale or even larger than the standard supermarkets operated by Kroger, Safeway, Publix, and other chains.

Exhibit 3

Whole Foods Market's Core Values

Our Core Values

The following list of core values reflects what is truly important to us as an organization. These are not values that change from time to time, situation to situation or person to person, but rather they are the underpinning of our company culture. Many people feel Whole Foods is an exciting company of which to be a part and a very special place to work. These core values are the primary reasons for this feeling, and they transcend our size and our growth rate. By maintaining these core values, regardless of how large a company Whole Foods becomes, we can preserve what has always been special about our company. These core values are the soul of our company.

Selling the Highest Quality Natural and Organic Products Available

- **Passion for Food**—We appreciate and celebrate the difference natural and organic products can make in the quality of one's life.
- **Quality Standards**—We have high standards and our goal is to sell the highest quality products we possibly can. We define quality by evaluating the ingredients, freshness, safety, taste, nutritive value, and appearance of all of the products we carry. We are buying agents for our customers and not the selling agents for the manufacturers.

Satisfying and Delighting Our Customers

- **Our Customers**—They are our most important stakeholders in our business and the lifeblood of our business. Only by satisfying our customers first do we have the opportunity to satisfy the needs of our other stakeholders.
- **Extraordinary Customer Service**—We go to extraordinary lengths to satisfy and delight our customers. We want to meet or exceed their expectations on every shopping trip. We know that by doing so we turn customers into advocates for our business. Advocates do more than shop with us; they talk about Whole Foods to their friends and others. We want to serve our customers competently, efficiently, knowledgeably, and with flair.
- **Education**—We can generate greater appreciation and loyalty from all of our stakeholders by educating them about natural and organic foods, health, nutrition, and the environment.
- **Meaningful Value**—We offer value to our customers by providing them with high quality products, extraordinary service, and a competitive price. We are constantly challenged to improve the value proposition to our customers.
- **Retail Innovation**—We value retail experiments. Friendly competition within the company helps us to continually improve our stores. We constantly innovate and raise our retail standards and are not afraid to try new ideas and concepts.
- **Inviting Store Environments**—We create store environments that are inviting and fun, and reflect the communities they serve. We want our stores to become community meeting places where our customers meet their friends and make new ones.

Team Member Happiness and Excellence

- **Empowering Work Environments**—Our success is dependent upon the collective energy and intelligence of all of our Team Members. We strive to create a work environment where motivated Team Members can flourish and succeed to their highest potential. We appreciate effort and reward results.
- **Self-Responsibility**—We take responsibility for our own success and failures. We celebrate success and see failures as opportunities for growth. We recognize that we are responsible for our own happiness and success.
- **Self-Directed Teams**—The fundamental work unit of the company is the self-directed Team. Teams meet regularly to discuss issues, solve problems, and appreciate each others' contributions. Every Team Member belongs to a Team.
- **Open & Timely Information**—We believe knowledge is power and we support our Team Members' right to access information that impacts their jobs. Our books are open to our Team Members, including our annual individual compensation report. We also recognize everyone's right to be listened to and heard regardless of their point of view.
- **Incremental Progress**—Our company continually improves through unleashing the collective creativity and intelligence of all of our Team Members. We recognize that everyone has a contribution to make. We keep getting better at what we do.

Exhibit 3 (continued)

- **Shared Fate**—We recognize there is a community of interest among all of our stakeholders. There are no entitlements; we share together in our collective fate. To that end we have a salary cap that limits the compensation (wages plus profit incentive bonuses) of any Team Member to fourteen times the average total compensation of all full-time Team Members in the company.

Creating Wealth Through Profits & Growth

- **Stewardship**—We are stewards of our shareholders' investments and we take that responsibility very seriously. We are committed to increasing long-term shareholder value.
- **Profits**—We earn our profits every day through voluntary exchange with our customers. We recognize that profits are essential to creating capital for growth, prosperity, opportunity, job satisfaction, and job security.

Caring About Our Communities & Our Environment

- **Sustainable Agriculture**—We support organic farmers, growers, and the environment through our commitment to sustainable agriculture and by expanding the market for organic products.
- **Wise Environmental Practices**—We respect our environment and recycle, reuse, and reduce our waste wherever and whenever we can.
- **Community Citizenship**—We recognize our responsibility to be active participants in our local communities. We give a minimum of 5 percent of our profits every year to a wide variety of community and non-profit organizations. In addition, we pay our Team Members to give of their time to community and service organizations.
- **Integrity in All Business Dealings**—Our trade partners are our allies in serving our stakeholders. We treat them with respect, fairness, and integrity at all times and expect the same in return.

Source: www.wholefoodsmarket.com (accessed March 21, 2008).

Exhibit 4

Major Acquisitions by Whole Foods Market, 1992–2007

YEAR	COMPANY ACQUIRED	LOCATION	NUMBER OF STORES	ACQUISITION COSTS
1992	Bread & Circus	Northeastern United States	6	$20 million plus $6.2 million in common stock
1993	Mrs. Gooch's	Southern California	7	2,970,596 shares of common stock
1996	Fresh Fields Markets	East Coast and Chicago area	22	4.8 million shares of stock plus options for 549,000 additional shares
1997	Merchant of Vino	Detroit area	6	Approximately 1 million shares of common stock
1997	Bread of Life	South Florida	2	200,000 shares of common stock
1999	Nature's Heartland	Boston area	4	$24.5 million in cash
2000	Food 4 Thought (Natural Abilities, Inc.)	Sonoma County, CA	3	$25.7 million in cash, plus assumption of certain liabilities
2001	Harry's Farmer's Market	Atlanta	3	Approximately $35 million in cash
2004	Fresh & Wild	Great Britain	7	$20 million in cash plus 239,000 shares of common stock
2007	Wild Oats Natural Marketplace	United States and Canada	74 (after sale of 35 stores)	$565 million plus the assumption of $137 million in debt; however, Whole Foods received approximately $166 million for the 35 stores that were subsequently sold (out of the total of 109 stores that were acquired)

Source: Investor relations section of www.wholefoodsmarket.com (accessed November 18, 2004, and March 21, 2008).

THE WILD OATS MARKET ACQUISITION In 2007, Whole Foods moved to purchase struggling Wild Oats Markets—Whole Foods' biggest competitor in natural and organic foods—for $700 million. Wild Oats operated 109 stores in 23 states under the Wild Oats Market, Henry's Farmer's Market, and Sun Harvest brands and had total annual sales of about $1.2 billion. The Federal Trade Commission (FTC) opposed the acquisition on grounds that the competition in the organic foods retailing segment would be weakened; however, a U.S. district court found that the FTC's position lacked merit. When the district court's ruling was upheld on appeal, Whole Foods was legally cleared to complete its acquisition of Wild Oats in late August 2007. Acquiring Wild Oats gave Whole Foods entry into 15 new metropolitan markets and 5 new states. Whole Foods then quickly sold 35 Henry's and Sun Harvest stores in California and Texas previously acquired by Wild Oats, along with a California distribution center, to Los Angeles food retailer Smart & Final, realizing almost $166 million from the sale and reducing its net purchase price for Wild Oats Market to about $534 million (which included the assumption of $137 million in Wild Oats' debt). In addition, Whole Foods immediately closed nine Wild Oats stores that did not fit with its brand strategy or real estate strategy and began planning to relocate seven smaller Wild Oats stores to existing or soon-to-be-opened Whole Foods locations.

Whole Foods' CEO, John Mackey, believed that the addition of the Wild Oats stores would give Whole Foods additional bargaining power with suppliers, boost the overall utilization of the company's facilities, and allow general and administrative expenses for the combined companies to be reduced significantly. Moreover, while Wild Oats stores were older and smaller than Whole Foods stores (the average Wild Oats store was 24,100 square feet versus a Whole Foods average of 34,000 square feet), management believed that over time it would be able to boost customer traffic and sales per square foot at the former Wild Oats stores to levels in line with those at Whole Foods stores. Three months after the close of the acquisition, sales at Wild Oats stores were said to be "rapidly improving" due to expanded product offerings and price cuts on more than 1,000 items.[6] During 2008, Whole Foods planned to spend close to $45 million renovating Wild Oats stores and rebranding them as Whole Foods stores.

Store Sizes and Locations

Whole Foods' stores had an open format and generated average annual sales of about $32 million. The company's "sweet spot" for most markets it had entered since 2000 was a store footprint between 45,000 and 60,000 square feet. All told, in early 2008, it had 82 stores that were 40,000 square feet or larger—the biggest was a 99,800-square-foot store in London. The 100-plus stores that company had opened since 2000 averaged 48,000 square feet, and 18 Whole Foods stores were over 60,000 square feet. Whole Foods had the two largest supermarket stores in New York City, a 58,000-square-foot store on Columbus Circle in Manhattan and a 71,000-square-foot store in the Bowery. Whole Foods had a 74,500-square-foot store in Columbus, Ohio; a flagship 78,000-square-foot store in Austin, Texas; a 77,000-square-foot store in Pasadena, California; and two 75,000-square-foot stores in the suburbs of Atlanta, Georgia. It was the company's practice each year not only to open new stores but also to relocate some of its smaller stores to larger sites with improved visibility and parking. In early 2008, the company had 89 stores averaging 51,500 square feet in varying stages of development; 13 of these were over 65,000 square feet (the new stores of supermarket chains like Safeway and Kroger averaged around 55,000 square feet), and 15 were in new geographic markets. Exhibit 5 provides store-related statistics.

In 2008, Whole Foods had stores in 36 states. Whole Foods favored store locations in the upscale areas of urban metropolitan centers, frequently on premier real estate sites. Most stores were in high-traffic shopping locations; some were freestanding, some were in strip centers, and some were in high-density mixed-use projects.

Exhibit 5

Number of Stores in the Whole Foods Markets Chain, 1991–2007, and Selected Store Operating Statistics, 2000–2007

YEAR	NUMBER OF STORES AT END OF FISCAL YEAR
1991	10
1992	25
1993	42
1994	49
1995	61
1996	68
1997	75
1998	87
1999	100
2000	117
2001	126
2002	135
2003	145
2004	163
2005	175
2006	186
2007	276

	FISCAL YEAR					
	2000	2002	2004	2005	2006	2007
Store sales (000s)	$1,838,630	$2,690,475	$3,864,950	$4,701,289	$5,607,376	$6,591,773
Average weekly sales	$324,710	$392,837	$482,061	$536,986	$593,439	$616,706
Comparable store sales growth*	8.6%	10.0%	14.9%	12.8%	11.0%	7.1%
Total square footage of all stores, end of year	3,180,207	4,098,492	5,145,261	5,819,843	6,376,817	9,312,107
Average store size, end of year, in square feet	27,181	30,359	31,566	33,200	34,284	33,740
Gross margin, all-store average	34.5%	34.6%	34.2%	35.1%	34.9%	34.8%
Store contribution, all-store average†	9.4%	9.6%	9.3%	9.6%	9.6%	8.9%

*Defined as average annual sales increases at stores open a full year or more; represents the rate at which sales at existing stores are increasing annually on average.

†Defined as gross profit minus direct store expenses, where gross profit equals store revenues less cost of goods sold.

Sources: Information posted at www.wholefoodsmarket.com (accessed March 14, 2008), and the company's 2007 10-K report.

Whole Foods had its own internally developed model to analyze potential markets according to education levels, population density, and income within certain drive times. After picking a target metropolitan area, the company's site consultant did a comprehensive site study and developed sales projections; potential sites had to pass certain financial hurdles. New stores opened 12 to 24 months after a lease was signed.

The cash investment needed to get a new Whole Foods Market site ready for opening varied with the metropolitan area, store size, amount of work performed by the landlord, and the complexity of site development issues—the average capital cost was $15.1 million in 2007.[7] In addition to the capital cost of a new store, it took about $850,000 to stock a store with inventory, a portion of which was financed by vendors.

Pre-opening expenses (including rent) averaged $2.6 million for the 21 new stores opened and relocated in fiscal 2007.

ProductLin e

While product and brand selections varied from store to store (because stores were different sizes and had different clientele), Whole Foods' product line included some 30,000 natural, organic, and gourmet food products and nonfood items:

- Fresh produce—fruits and vegetables, including seasonal, exotic, and specialty products like cactus pears, cippolini onions, and Japanese eggplant.
- Meat and poultry—natural and organic meats, house-made sausages, turkey, and chicken products from animals raised on wholesome grains, pastureland, and well water (and grown without the use of by-products, hormones, or steroids).
- Fresh seafood—a selection of fresh fish; shrimp; oysters; clams; mussels; homemade marinades; and exotic items like octopus, sushi, and black tip shark. A portion of the fresh fish selections at the seafood station came from the company's Pigeon Cove and Select Fish seafood processing subsidiaries. Seafood items coming from distant supply sources were flown in to stores to ensure maximumf reshness.
- A selection of daily baked goods—breads, cakes, pies, cookies, bagels, muffins, and scones.
- Prepared foods—soups, canned and packaged goods, oven-ready meals, rotisserie meats, hearth-fired pizza, pastas, patés, salad bars, a sandwich station, and a selection of entrées and side foods prepared daily.
- Fine-quality cheeses, olives (up to 40 varieties in some stores), chocolates, and confections.
- Frozen foods, juices, yogurt and dairy products, smoothies, and bottled waters.
- A wide selection of dried fruits, nuts, and spices (either prepackaged or dispensed fromb ins).
- Beer and wines—the selection of domestic and imported wines varied from store to store. Organic wines were among those available.
- Coffees and teas—the company's Allegro coffee subsidiary supplied all stores with specialty and organic coffees, and several of the newer stores had in-store coffee-roasting equipment that allowed customers to order any of 20 varieties to be roasted while they shopped. The tea selections included environmentally correct, premium exotic teas from remote forests. Most stores had a coffee and tea bar where shoppers could enjoy freshly brewed drinks.
- A body care and nutrition department containing a wide selection of natural and organic body care products and cosmetics, along with assorted vitamin supplements, homeopathic remedies, yoga supplies, and aromatherapy products—all items entailed the use of non-animal testing methods and contained no artificial ingredients.
- Natural and organic pet foods (including the company's own private-label line), treats, toys, and pest control remedies.
- Grocery and household products—canned and packaged goods, pastas, soaps, cleaning products, and other conventional household items that helped make Whole Foods' larger stores a one-stop grocery shopping destination where people could get everything on their shopping list.
- A floral department with sophisticated flower bouquets and a selection of plants for inside and outside the home.
- A "365 Everyday Value" line and a "365 Organic Everyday Value" line of private-label products that were less expensive than comparable name brands, as well as a family of private-label products with consistent logos and packaging for specific departments—examples included "Whole

Kitchen" for prepackaged fresh and frozen grocery items; "Whole Treat" for cookies, candies, and frozen desserts; "Whole Pantry" for herbs, spices, and condiments; and "Whole Catch" for prepackaged fresh and frozen seafood items.

- Educational products (information on alternative health care) and books relating to healing, cookery, diet, and lifestyle. In some stores, there were cooking classes and nutrition sessions.

Whole Foods was the world's biggest seller of organic produce. Perishables accounted for about 67 percent of Whole Foods' sales in 2007, considerably higher than the 40–50 percent that perishables represented at conventional supermarkets. The acquisition of the three 75,000-plus-square-foot Harry's Market superstores in Atlanta, where 75 percent of sales were perishables, had provided the company with personnel having valuable intellectual capital in creatively merchandising all major perishables categories. Management believed that the company's emphasis on fresh fruits and vegetables, bakery goods, meats, seafood, and other perishables differentiated Whole Foods stores from other supermarkets and attracted a broader customer base. According to John Mackey:

> First-time visitors to Whole Foods Market are often awed by our perishables. We devote more space to fresh fruits and vegetables, including an extensive selection of organics, than most of our competitors. Our meat and poultry products are natural—no artificial ingredients, minimal processing, and raised without the use of artificial growth hormones, antibiotics, or animal by-products in their feed. Our seafood is either wild-caught or sourced from aquaculture farms where environmental concerns are a priority. Also, our seafood is never treated with chlorine or other chemicals, as is common practice in the food retailing industry. With each new store or renovation, we challenge ourselves to create more entertaining, theatrical, and scintillatingly appetizing prepared foods areas. We bake daily, using whole grains and unbleached, unbromated flour and feature European-style loaves, pastries, cookies, and cakes as well as gluten-free baked goods for those allergic to wheat. We also offer many vegetarian and vegan products for our customers seeking to avoid all animal products. Our cheeses are free of artificial flavors, colors, and synthetic preservatives, and we offer an outstanding variety of both organic cheeses and cheeses made using traditional methods.[8]

Whole Foods' three-story showcase Union Square store in Manhattan carried locally made New York offerings, seasonal items from the nearby Greenmarket farmer's market, and numerous exotic and gourmet items. A 28-foot international section featured such items as Lebanese fig jam, preserved lemons from Morocco, Indian curries, Thai rice, stuffed grape leaves from Greece, and goulash from Hungary. The prepared foods section had a Grilling Station where shoppers could get grilled-to-order dishes such as swordfish in red pepper Romesco sauce and steak with a mushroom demi-glace.

One of Whole Foods Market's foremost commitments to its customers was to sell foods that met strict standards and that were of high quality in terms of nutrition, freshness, appearance, and taste. Whole Foods guaranteed 100 percent satisfaction on all items purchased and went to great lengths to live up to its core value of satisfying and delighting customers. Buyers personally visited the facilities of many of the company's suppliers and were very picky about the items they chose and the ingredients they contained. For the benefit of prospective food suppliers, the company maintained a list of ingredients it considered unacceptable in food products. Exhibit 6 shows the company's quality standards.

PRICING Because the costs of growing and marketing organic foods ran 25 to 75 percent more than conventionally grown items, prices at Whole Foods were higher than at conventional supermarkets. For the most part, Whole Foods sold premium products at premium prices. Price-sensitive consumers and some media critics had dubbed Whole Foods as "Whole Paycheck." Some of the exotic items sold at Whole Foods had eye-popping price

Exhibit 6

Whole Foods Market's Product Quality Standards and Customer Commitments

Our business is to sell the highest quality foods we can find at the most competitive prices possible. We evaluate quality in terms of nutrition, freshness, appearance, and taste. Our search for quality is a never-ending process involving the careful judgment of buyers throughout the company.

- We carefully evaluate each and every product we sell.
- We feature foods that are free of artificial preservatives, colors, flavors, sweeteners, and hydrogenated fats.
- We are passionate about great tasting food and the pleasure of sharing it with others.
- We are committed to foods that are fresh, wholesome, and safe to eat.
- We seek out and promote organically grown foods.
- We provide food and nutritional products that support health and well-being.

Whole Foods Market's Quality Standards team maintains an extensive list of unacceptable ingredients. . . . However, creating a product with no unacceptable ingredients does not guarantee that Whole Foods Market will sell it. Our buyers are passionate about seeking out the freshest, most healthful, minimally processed products available. [As of 2008, there were 81 chemicals on Whole Foods' list of unacceptable ingredients, including artificial colors, artificial flavors, aspartame, bleached flour, cyclamates, foie gras, hydrogenated fats, irradiated foods, nitrates and nitrites, saccharin, sorbic acid, sucralose, and sulfites (sulfur dioxide).]

Source: The quality standards section of www.wholefoodsmarket.com (accessed March 24, 2008).

tags—for example, Graffiti eggplants grown in Holland were $4 per pound, lobster mushrooms from Oregon were $25 per pound, and a three-ounce can of organic pearl jasmine tea was $14.[9] The earth-friendly detergents, toilet papers, and other household items that Whole Foods merchandised frequently were priced higher than the name brands of comparable products found in traditional supermarkets. However, as one analyst noted, "If people believe that the food is healthier and they are doing something good for themselves, they are willing to invest a bit more, particularly as they get older. It's not a fad."[10] Another grocery industry analyst noted that while Whole Foods served a growing niche, it had managed to attract a new kind of customer, one who was willing to pay a premium to dabble in health food without being totally committed to vegetarianism or an organicl ifestyle.[11]

StoreD escriptionan d Merchandising

Whole Foods Market did not have a standard store design. Instead, each store's layout was customized to fit the particular site and building configuration and to best show off the particular product mix for the store's target clientele. The driving concept of Whole Foods' merchandising strategy was to create an inviting and interactive store atmosphere that turned shopping for food into a fun, pleasurable experience. Management at Whole Foods wanted customers to view company stores as a "third place" (besides home and office) where people could gather, learn, and interact while at the same time enjoying an intriguing food-shopping and eating experience. Stores had a colorful décor, and products were attractively merchandised (see Exhibit 7). According to one industry analyst, Whole Foods had "put together the ideal model for the foodie who's a premium gourmet and the natural foods buyer. When you walk into a Whole Foods store, you're overwhelmed by a desire to look at everything you see."[12]

Most stores featured hand-stacked produce, in-store chefs working in open kitchens, scratch bakeries, prepared-foods stations, European-style charcuterie departments, "Whole Body" departments with a wide selection of personal care items and natural cosmetics (as well as a makeup station), salad bars, sit-down dining areas, gourmet food sections with items

EXHIBIT 7 Scenes from Whole Foods Stores

from around the world, and ever-changing selections and merchandise displays. Many stores had recipe cards at the end of key aisles. A few stores offered valet parking, home delivery, and massages. Management believed that the extensive and attractive displays of fresh produce, seafood, meats and house-made sausages (up to 40 varieties), baked goods, and prepared foods in its larger stores appealed to a broader customer base and were responsible for the fact that Whole Foods stores larger than 30,000 square feet were generally better performers than smaller stores.

Whole Foods' 78,000-square-foot flagship Austin store was a top central Texas tourist destination and a downtown Austin landmark; it had an intimate village-style layout; six mini restaurants within the store; a raw food and juice bar; more than 600 varieties of cheese and 40 varieties of olives; a selection of 1,800 wines; a Candy Island with handmade lollipops and popcorn balls; a hot nut bar with an in-house nut roaster; a world foods section; a walk-in beer cooler with 800 selections; 14 pastry chefs making a variety of items; a natural home section with organic cotton apparel and household linens; an extensive meat department with an in-house smoker and 50 oven-ready items prepared by in-house chefs; and a theater-like seafood department with more than 150 fresh seafood items and on-the-spot shucking, cooking, smoking, slicing, and frying to order. The Columbus Circle store in Manhattan had a 248-seat café where shoppers could enjoy restaurant-quality prepared foods while relaxing in a comfortable community setting; a Jamba Juice smoothie station that served freshly blended-to-order fruit smoothies and juices; a full-service sushi bar by Genji Express where customers sat on bar stools enjoying fresh-cut sushi wrapped in organic seaweed; a walk-in greenhouse showcasing fresh-cut and exotic flowers; a wine shop with more than 700 varieties of wine from both large and small vineyards and family estates; and a chocolate enrobing station in the bakery where customers could request just about anything covered in chocolate. The two-story store in Pasadena, California (Whole Foods' largest store west of the Rocky Mountains), had a wine and tapas lounge; a seafood bar; an Italian trattoria; 1,200 selections of wine; fresh doughnuts made hourly; a 6,000-square-foot produce department that featured more than 500 items daily; and free wireless Internet access. The three-story, 99,800-square-foot store in London had 55 in-store chefs; 13 dining venues (including a tapas bar, a champagne and oyster bar, a pub, and a sushi and dim sum eatery) that accommodated 350 diners; a self-service bulk foods center with 100 selections; and a 12-meter display of fresh seafood (many of the seafood selections were hook-and-line caught off the shores of the United Kingdom).

Whole Foods got very high marks from merchandising experts and customers for its presentation— from the bright colors of the produce displays, to the quality of the foods and customer service, to the wide aisles and cleanliness. Management was continually experimenting with new merchandising concepts to keep stores fresh and exciting for customers. According to a Whole Foods regional manager, "We take the best ideas from each of our stores and try to incorporate them in all our other stores. We're constantly making our stores better."[13] Whole Foods' merchandising skills were said to be a prime factor in its success in luring shoppers back time and again—Whole Foods stores had annual sales averaging more than $800 per square foot of space (about double the sales per square foot of Kroger and Safeway).

To further a sense of community and interaction with customers, stores typically included customer comment boards and "Take Action" centers for customers who wanted information on such topics as sustainable agriculture, organics, overfishing problems and the sustainability of seafood supplies, the environment, and similar issues. The Toronto store had biographies of farmers suspended from the ceiling on placards and a board calling attention to Whole Foods' "Sustainable Seafood Policy" hung above the seafood station. In 2008, Whole Foods began introducing signage and brochures in all its stores informing shoppers of the company's Five-Step Animal Welfare Rating Program, which laid out a set of "animal compassionate" standards expected of Whole Foods' meat and poultry suppliers; these standards focused on humane living conditions for the animals and specified permissible and prohibited production and handling techniques from parent stock throughs laughter.

Marketing and Customer Service

Whole Foods spent about 0.5 percent of its revenues on advertising, a much smaller percentage than conventional supermarkets, preferring instead to rely primarily on word-of-mouth recommendations and testimonials from customers. The corporate marketing budget was allocated to regionwide programs, marketing efforts for individual stores, and a national brand-awareness initiative focused primarily on national in-store marketing programs. Stores spent most of their marketing budgets on in-store signage and store events such as taste fairs, classes, and product samplings. Store personnel were encouraged to extend company efforts to encourage the adoption of a natural and organic lifestyle by going out into the community and conducting a proactive public relations campaign. Each store also had a separate budget for making contributions to philanthropic activities and community outreach programs.

Since one of its core values was to satisfy and delight customers (see Exhibit 3), Whole Foods Market empowered team members to do whatever it took to meet or exceed customer expectations on every shopping trip. Competent, knowledgeable, and friendly service was a hallmark of shopping at a Whole Foods Market. The aim was to turn highly satisfied customers into advocates for Whole Foods who talked to close friends and acquaintances about their positive experiences shopping at Whole Foods. Store personnel were personable and chatty with shoppers. Customers could get personal attention in every department of the store. When customers asked where an item was located, team members often took them to the spot, making conversation along the way and offering to answer any questions. Team members were quite knowledgeable and enthusiastic about the products in their particular department and tried to take advantage of opportunities to inform and educate customers about natural foods, organics, healthy eating, and food-related environmental issues. They took pride in helping customers navigate the extensive variety to make the best choices. Meat department personnel provided customers with custom cuts, cooking instructions, and personal recommendations.

StoreO perations

Whole Foods employed a team approach to store operations. Depending on store size and traffic volume, Whole Foods stores employed between 85 and 600 team members, who were organized into as many as 13 teams, each led by a team leader. Each team within a store was responsible for a different product category or aspect of store operations, such as customer service, prepared foods, produce, and customer checkout stations. Teams were empowered to make many decisions at the store level pertaining to merchandising, departmental operations, and efforts to please customers.

Whole Foods' commitment to team-based management of store operations stemmed from the conviction that the company's long-term success was advanced by having happy employees actively helping to create happy customers. The team approach, complemented by a strong emphasis on empowering employees, was seen as promoting a strong corporate culture and contributing to a work environment where motivated team members could flourish, build a career, and reach their highest potential. Whole Foods' top management believed that empowered teams helped harness the collective energy and intelligence of team members to operate their departments effectively and efficiently—thereby enabling Whole Foods to manage its stores better than rival supermarket chains managed their stores. Management also believed that team members were further motivated and inspired by the company's strategic vision—many team members felt good about their jobs and had a greater sense of purpose because the work they did contributed to better diets and eating habits on the part of Whole Foods shoppers and to the overall well-being of society at large. Indeed, many job candidates were drawn to interview at Whole Foods because they identified with the company's mission of selling natural and organic foods, advancing the cause of long-term sustainable agricultural practices, and promoting a cleaner environment—a mission that was captured and reflected in the company's motto of "Whole Foods, Whole People, Whole Planet."

A team member at Whole Foods' store in Austin, Texas, said, "I really feel like we're a part of making the world a better place. When I joined the company 17 years ago, we only had four stores. I have always loved—as a customer and now as a Team Member—the camaraderie, support for others, and progressive atmosphere at Whole Foods Market."[14] According to the company's vice president of human resources, "Team members who love to take initiative, while enjoying working as part of a team and being rewarded through shared fate, thrive here."

Top executives at Whole Foods were acutely aware that the company's decentralized team approach to store operations—where many personnel, merchandising, and operating decisions were made by teams at the individual store level—made it critical to have an effective store team leader. The store team leader worked with one or more associate store team leaders, as well as with all the department team leaders, to operate the store as efficiently and profitably as possible. Team leaders screened candidates for job openings on their team, but a two-thirds majority of the team had to approve a new hire—and that approval came only after a 30-day trial for the candidate. Store team leaders were paid a salary plus a bonus based on the store's economic value added (EVA) contribution; they were also eligible to receive stock options.[15] Twice yearly, team members were asked to complete a confidential, third-party administered team leader survey that provided them with an opportunity to give team leaders constructive feedback. Store team leaders reported directly to one of 11 regional presidents.

Starting in 2002, team members across the company were encouraged to actively contribute ideas about the benefits they would like the company to offer. The suggestions were compiled, put into a choice of packages, and the choices submitted to team members for a vote. The benefits plan that was adopted for 2003 through 2006 was approved by 83 percent of the 79 percent of the team members participating in the benefits vote. Under the adopted plan, team members could select their own benefits package. The resulting health insurance plan that the company put in place in January 2003 involved the company paying 100 percent of the premium for full-time employees and the establishment of company-funded "personal wellness accounts," which team members could use to pay the higher deductibles; any unused balances in a team member's account could roll over and accumulate for future expenses. A second companywide benefits vote was held in fiscal 2006 to determine the benefits program that would be in place from 2007 through 2009. One outcome of the second vote, in which approximately 77 percent of eligible team members participated, was that the company again provided health care at no cost to eligible full-time employees (defined as those who worked 30 or more hours per week and had worked a minimum of 800 hours); the cost of dependent health care premiums was shared between the company and the team member, with the percentage paid by the team member declining as years of service with the company increased. Other key benefits included paid time off, a 20 percent discount on all purchases at Whole Foods, dental and eye care plans, life insurance and disability insurance plans, and an emergency assistance plan.

Every year, management gave team members an opportunity to complete a morale survey covering job satisfaction, opportunity and empowerment, pay, training, and benefits. In 2004, the overall participation rate was 63 percent (versus 71 percent in 2003). Of the team members responding in 2004, 86 percent said they almost always or frequently enjoyed their job (the same percentage as in 2003), and 82 percent said they almost always or frequently felt empowered to do their best work at Whole Foods Market (up slightly from 81 percent in 2003). Common responses to the question "What is the best thing about working at Whole Foods Market?" included coworkers, customers, flexibility, work environment, growth and learning opportunities, the products Whole Foods sold, benefits, the team concept, and the culture of empowerment.

Whole Foods Market had 54,000 employees in 2008, of whom approximately 85 percent were full-time. None were represented by unions, although there had been a couple of unionization attempts. John Mackey was viewed as fiercely anti-union and had once said: "The union is like having herpes. It doesn't kill you, but it's unpleasant and inconvenient and it stops a lot of people from becoming your lover."[16] When workers at a Whole Foods Market in Madison, Wisconsin, voted to unionize in 2002, John Mackey spent over nine months going to all of the company's stores to speak with store employees personally, listen to what was on their minds, and gather suggestions for improving working conditions. Unionization efforts had never made any headway at Whole Foods, and the company was widely regarded as very progressive and genuinely committed to creating a positive, satisfying work environment.

Whole Foods had made *Fortune*'s "100 Best Companies to Work For" list for 11 consecutive years (1998–2008); it was one of only 14 companies to make the list every year since its inception and was the only national supermarket chain to ever make the list (although Wegmans, a regional supermarket chain, was the top-ranked company on *Fortune*'s 2005 list and was the third-ranked company in both 2007 and 2008). In scoring companies, *Fortune* placed two-thirds weight on responses to a 57-question survey of 400 randomly selected employees and one-third on *Fortune*'s own evaluation of a company's demographic makeup, pay and benefits, and culture.

Compensationan dI ncentives

Whole Foods strived to create a "shared-fate consciousness" on the part of team members by uniting the self-interests of team members with those of shareholders. One way management reinforced this concept was through a gain-sharing program that rewarded a store's team members according to their store's contribution to operating profit (store sales less cost of goods sold less store operating expenses)—gain-sharing distributions added 5 to 7 percent to team member wages. The company also encouraged stock ownership on the part of team members through three other programs:

1. *A team member stock option plan.* All full-time and part-time team members were eligible for a grant of stock options each year based on team member performance and length of service to the company. In 2007, options to purchase 1.7 million shares were granted to 13,400 team members.
2. *A team member stock purchase plan.* Through payroll deductions, team members could purchase a restricted number of shares at 95 percent of the market price on the purchase date. Approximately 2,000 team members participated in this plan in fiscal 2007.
3. *A team member 401(k) plan.* Whole Foods Market stock was one of the investment options in the 401(k) plan.

All the teams at each store were continuously evaluated on measures relating to sales, operations, and morale; the results were made available to team members and to headquarters personnel.[17] Teams competed not only against the goals they had set for themselves but also against other teams at their stores or in their region—competition among teams was encouraged. In addition, stores went through two review processes—a store tour and a "customer snapshot." Each store was toured periodically and subjected to a rigorous evaluation by a group of 40 personnel from another region; the group included region heads, store team leaders, associate team leaders, and leaders from two operating teams. Customer snapshots involved a surprise inspection by a headquarters official or regional president who rated the store on 300 items; each store had 10 surprise inspections annually, with the results distributed to every store and included in the reward system. Rewards were team-based and tied to performance metrics.

Whole Foods had a salary cap that limited the compensation (wages plus profit incentive bonuses) of any team member to 19 times the average total compensation of all full-time team members in the company—a policy mandated in the company's core values (see Exhibit3). The salary cap was raised from 14 to 19 times the average total compensation in 2007—it had been 8 times in 2003; the increases stemmed from the need to attract and retain key executives. For example, if the average total compensation was $50,000, then a cap of 19 times the average meant that an executive could not be paid more than $950,000. All team members had access to the company's financial books, including an annual compensation report listing the gross pay of each team member and company executive. Cofounder and CEO John Mackey had recently reduced his annual salary to $1, with future compensation from his personal stock options going to Whole Foods' two not-for-profit foundations.

The company promoted from within as much as possible, with team members often moving up to assume positions at stores soon to be opened or at stores in other regions.

THE USE OF ECONOMIC VALUE ADDED TO MEASURE PERFORMANCE

In 1999, Whole Foods adopted an economic value added (EVA) management and incentive system. EVA is defined as net operating profits after taxes minus a charge for the cost of capital necessary to generate that profit. At Whole Foods, EVA at the store level was based on store contribution (store revenues minus cost of goods sold minus store operating expenses) relative to store investment over and above a weighted average cost of capital of 9 percent—average store contribution percentages for 2000–2007 are shown in Exhibit 5. Senior executives managed the company with the goal of *improving* EVA at the store level and companywide; they believed that an EVA-based bonus system was the best financial framework for team members to use in helping make decisions that created sustainable shareholder value. The teams in all stores were challenged to find ways to boost store contribution and EVA—the team member bonuses paid on EVA improvement averaged 6 percent in 2003.

In 2007, more than 750 senior executives, regional managers, store team leaders, and assistant store team leaders throughout the company were on EVA-based incentive compensation plans. The primary measure for payout was EVA *improvement.* The company's overall EVA climbed from a negative $30.4 million in fiscal 2001 to $2.6 million in fiscal 2003, $15.6 million in fiscal 2004, $25.8 million in 2005, and $64.4 million in 2006, but then dropped sharply to $35.4 million in 2007.

In addition, management used EVA calculations to determine whether the sales and profit projections for new stores would yield a positive and large enough EVA to justify the investment. EVA calculations were also used to guide decisions on store closings and to evaluate new acquisitions.

Purchasing and Distribution

Whole Foods' buyers purchased most of the items retailed in the company's stores from local, regional, and national wholesale suppliers and vendors. Much of the buying responsibility was located at the regional and national levels in order to put the company in a better position to negotiate volume discounts with major vendors and distributors. Whole Foods Market was the largest account for many suppliers of natural and organic foods. United Natural Foods was the company's biggest supplier, accounting for about 24 percent of Whole Foods' total purchases in fiscal 2007; United was the company's primary supplier of dry grocery and frozen food products. However, regional and store managers had discretionary authority to source from local organic farmers and suppliers that meet the company's quality standards. In 2007–2008, the company's buyers began to place stronger emphasis on buying directly from producers and manufacturers.

Whole Foods owned two produce procurement centers that facilitated the procurement and distribution of the majority of the produce

Whole Foods sold. However, where feasible, local store personnel sourced produce items from local organic farmers as part of the company's commitment to promote and support organic farming methods. Two subsidiaries, the Pigeon Cove seafood processing facility in Massachusetts and the Select Fish seafood processing facility on the West Coast, supplied a portion of the company's seafood requirements. A regional seafood distribution facility had recently been established in Atlanta.

The company operated nine regional distribution centers to supply its stores. Nine regional bake houses and five commissary kitchens supplied area stores with various prepared foods. A central coffee-roasting operation supplied stores with the company's Allegro brand of coffees.

CommunityC itizenship and Social Activism

Whole Foods demonstrated its social conscience and community citizenship in a variety of ways:

- By donating at least 5 percent of its after-tax profits in cash or products to nonprofit or educational organizations. In fiscal 2007, Whole Foods made charitable donations of just under $15 million, equal to about 8 percent of after-tax profits in fiscal 2007.
- Whole Foods' Green Mission Task Force promoted environmentally sound practices for every aspect of store and facility operations. In early 2008, Whole Foods began using all-natural-fiber packaging at its salad and food bars. As of Earth Day 2008 (April 22), Whole Foods ended the use of disposable plastic bags at the checkout lanes of all its stores, chiefly because such bags did not break down in landfills. Company officials said the move would eliminate use of 100 million plastic bags annually—in their place, customers were offered reusable paper bags made of 100 percent recycled paper (at a cost of 10 cents each) and an opportunity to purchase stylish long-life canvas bags for 99 cents (80 percent of the content of the canvas bags came from recycled plastic bottles).
- The company was in the process of converting its distribution fleet vehicles to biodieself uel.
- The company purchased renewable energy credits to offset 100 percent of the electricity used in all of its locations (retail and nonretail) in North America. In both 2006 and 2007, Whole Foods won a Green Power Partnership award from the U.S. Environmental Protection Agency for supporting the development of renewable energy.
- Whole Foods created the not-for-profit Animal Compassion Foundation in January 2005, which strived to help producers adopt and improve their practices for raising farm animals naturally and humanely.
- In October 2005, Whole Foods had established a not-for-profit Whole Planet Foundation that was charged with combating poverty and promoting self-sufficiency in third-world countries that supplied Whole Foods with some of the products it sold.
- Whole Foods participated in a Whole Trade program that committed the company to paying small-scale producers (chiefly in impoverished, low-wage countries where living standards were low) a price for their products that more than covered the producer's costs; the goal was to make sure that the producers of products meeting Whole Foods' quality standards could always afford to create, harvest or grow their product so that they did not have to abandon their work or jeopardize the well-being of their family to make ends meet. The commitment to paying such producers a premium price was viewed as an investment in such producers and their communities, a way for producers to be able to put money back into their operations, enable them to invest in training and education for their workers, and have sufficient take-home pay to help support a better life. Whole Foods' goal was to have more than

50 percent of its products imported from developing nations meet its Whole Trade qualifications within 10 years. In 2007, the Whole Trade Guarantee label was featured on more than 400 items at Whole Foods' stores. Whole Foods donated 1 percent of the retail sale of each Whole Trade product sold to the Whole Planet Foundation.

- In 2007, Whole Foods established a Local Producer Loan Program that awarded low-interest loans to small-scale food producers and growers. So far, Whole Foods had committed $10 million to its microlending program to help aspiring local producers of organic and natural agricultural crops, body care products, and artisan foods (such as nut butters, ice cream, granolas, and cheeses) to grow and flourish. Loan recipients had to meet Whole Foods Market's quality standards, use the funds for expansion, and have a viable business plan. Loan amounts were between $1,000 and $100,000 with fixed interest rates that ranged between 5 and 9 percent in 2007.
- Team members at every Whole Foods store were heavily involved in such community citizenship activities as sponsoring blood donation drives, preparing meals for seniors and the homeless, holding fundraisers to help the disadvantaged, growing vegetables for a domestic violence shelter, participating in housing renovation projects, and working as deliverypeople for Meals on Wheels.
- Individual Whole Foods stores held "5% Days" (or "Community Giving Days"), donating 5 percent of that day's net store sales to a local or regional nonprofit or educational organization.

In an effort to "walk the talk" about its commitment to its core values and "Whole Foods, Whole People, Whole Planet" motto, Whole Foods had gathered information about key issues that could affect people's health and well-being—the genetic engineering of food supplies, food irradiation practices, and the organic standards process—and disseminated that information via in-store brochures, presentations to groups, and postings on the company's Web site. Further, the company had developed position statements on sustainable seafood practices (see Exhibit 8), the merits of organic farming, and wise environmental practices. Whole Foods regularly publicized its position statements in its stores and on its Web site, along with the company's commitment to selling only those meats that had been raised without the use of growth hormones, antibiotics, and animal by-products.

MACKEY'S ETHICS ARE CALLED INTO QUESTION *Business Ethics* named Whole Foods Market to its list of the "100 Best Corporate Citizens" in 2004, 2006, and 2007. However, during 2007, CEO John Mackey was the center of attention in two ethics-related incidents. The first involved a discovery that, over a seven-year period, Mackey had typed out more than 1,100 entries on Yahoo Finance's message board touting his company's stock and occasionally making uncomplimentary remarks about rival Wild Oats Markets. Mackey's postings stopped several months prior to Whole Foods' offer to buy Wild Oats Market. In making his postings, Mackey used the alias Rahodeb—a variation of his wife's name, Deborah. *The Wall Street Journal* reported that in January 2005 Rahodeb posted that no one would buy Wild Oats at its current price of $8 per share and that Whole Foods had nothing to gain by buying Wild Oats because Wild Oats' stores were too small.[18] A *New York Times* article reported that, on March 28, 2006, Rahodeb wrote, "OATS has lost their way and no longer has a sense of mission or even a well-thought-out theory of the business. They lack a viable business model that they can replicate. They are floundering around hoping to find a viable strategy that may stop their erosion. Problem is they lack the time and the capital now."[19] The *New York Times* article quoted Mackey as saying, "I posted on Yahoo! under a pseudonym because I had fun doing it. I never intended any of those postings to be identified with me." Mackey's postings, which came to light in June–July 2007 and spurred calls for

Exhibit 8

Whole Foods' Position on Seafood Sustainability

The simple fact is our oceans are soon to be in trouble. Our world's fish stocks are disappearing from our seas because they have been overfished or harvested using damaging fishing practices. To keep our favorite seafood plentiful for us to enjoy and to keep it around for future generations, we must act now.

As a shopper, you have the power to turn the tide. When you purchase seafood from fisheries using ocean-friendly methods, you reward their actions and encourage other fisheries to operate responsibly.

At Whole Foods Market, we demonstrate our long-term commitment to seafood preservation by:

- Supporting fishing practices that ensure the ecological health of the ocean and the abundance of marine life.
- Partnering with groups who encourage responsible practices and provide the public with accurate information about the issue.
- Operating our own well-managed seafood facility and processing plant, Pigeon Cove Seafood, located in Gloucester, Massachusetts.
- Helping educate our customers on the importance of practices that can make a difference now and well into the future.
- Promoting and selling the products of well-managed fisheries.

Source: www.wholefoodsmarket.com (accessed November 26, 2004).

his resignation on grounds that he breached his fiduciary responsibility, were first discovered by the Federal Trade Commission (FTC) in Whole Foods' documents that the FTC obtained in the course of challenging the Wild Oats acquisition. According to Mackey, the views he expressed in his Rahodeb postings sometimes represented his personal beliefs and sometimes were different because he would occasionally play the role of devil's advocate. He said no proprietary information about Whole Foods was disclosed.[20] In the days following the media reports of the postings, Mackey expressed remorse for his postings, apologized for his behavior, and asked stakeholders to forgive him for exercising bad judgment. Nonetheless, certain Mackey postings were cited in court documents filed by the FTC as reasons why Whole Foods' acquisition of Wild Oats should be blocked. On July 17, 2007, the Securities and Exchange Commission (SEC) announced that it had begun an investigation of the postings. That same day, Whole Foods announced that the company's board of directors had formed a special committee to investigate the postings and retained legal counsel to advise it during the investigation. Whole Foods said it would cooperate fully with the SEC inquiry.

In October 2007, Whole Foods announced that the special committee had completed its investigation of Mackey's message board postings and that the board of directors affirmed its support of CEO John Mackey; the company indicated that the special committee's findings would be turned over to the SEC and that the company would have no further comment pending the SEC investigation.[21] As of April 2008, there had been no public announcement regarding the SEC's investigation of Mackey's postings.

A second controversy-stirring incident involved a Mackey-authored blog entitled "Whole Foods, Wild Oats and the FTC" that was posted on the company's Web site on June 19, 2007. Mackey, who objected strenuously to the grounds on which the FTC was trying to block Whole Foods' acquisition of Wild Oats, authored the blog, which was dedicated to posting updates and information regarding the FTC proceedings and to making the case for why the company's acquisition of Wild Oats Market should be allowed to go forward. Mackey explained the basis for the blog:

> My blog posting provides a detailed look into Whole Foods Market's decision-making process regarding the merger, as well as our

> company's experience interacting with the FTC staff assigned to this merger. I provide explanations of how I think the FTC, to date, has neglected to do its homework appropriately, especially given the statements made regarding prices, quality, and service levels in its complaint. I also provide a glimpse into the bullying tactics used against Whole Foods Market by this taxpayer-funded agency. Finally, I provide answers in my FAQ section to many of the questions that various Team Members have fielded from both the media and company stakeholders. As previously announced, we set an intention as a company to be as transparent as possible throughout this legal process, and this blog entry is my first detailed effort at transparency.

The blog posting by Mackey included the following headings:

- Why Whole Foods Market Wants to Buy WildO ats.
- Whole Foods Market's Objections to the FTC'sI nvestigation.
- What the FTC Is Claiming in Its Objections to the Merger.
- FAQs.

Critics of the Mackey blog posting said it was inappropriate for a CEO to publicly air the company's position, to take issue with the FTC, and to make the company's case for why the acquisition should be allowed to proceed. At the least, some critics opined, the blog should be toned down. When the SEC announced on July 17, 2007, that it would investigate John Mackey's financial message board postings, Mackey put a hold on further blog postings regarding the FTC's actions to try to block the Wild Oats acquisition.

WholeF oodsM arket's Financial Performance

Since becoming a public company in 1991, Whole Foods Market had been profitable every year except one—2000, which involved a net loss of $8.5 million. That loss stemmed from a decision to divest a nutritional supplement business and losses in two affiliated dot-com enterprises (Gaiam.com and WholePeople.com) in which Whole Foods owned a minority interest. The company's net income rose at a compound average rate of 17.6 percent from fiscal 2003 through fiscal 2007 despite a falloff in 2007 net income to $182.7 million from $203.8 million in 2006. Whole Foods paid its first quarterly dividend in January 2004; since then, dividends had been increased several times. The company began paying a quarterly dividend of $0.20 as of the first quarter of fiscal 2008; this dividend level resulted in cash outlays of about $28 million quarterly.

Whole Foods' business generated cash flows from operations of $410.8 million in fiscal 2005, $452.7 million in fiscal 2006, and $398.6 million in fiscal 2007. For the most part, the company's capital expenditures went into funding the development or acquisition of new stores and the acquisition of property and equipment for existing stores. Capital expenditures totaled $324.1 million in fiscal 2005, $340.2 million in fiscal 2006, and $529.7 million in fiscal 2007, of which $207.8 million, $208.6 million, and $389.3 million, respectively, was for new store development and $116.3 million, $131.6 million, and $140.3 million, respectively, was for remodeling and other additions. During fiscal 2008, Whole Foods expected capital expenditures to be in the range of $575 to $625 million, of which 65 to 70 percent was related to new store openings in 2008 and beyond and approximately 7 to 8 percent related to remodeling the acquired Wild Oats stores. To aid in financing the Wild Oats acquisition and continue fast-paced opening of new stores, Whole Foods had taken on long-term debt of more than $700 million and negotiated a $250 million line of credit with its banks. Exhibits 9, 10, and 11 present the company's recent statements of operations and consolidated balance sheets.

Late-Breaking Developments at Whole Foods

In 2008, the souring U.S. economy hit Whole Foods rather hard. Sales increases at Whole Foods stores open at least a year rose a meager

Exhibit 9

Whole Foods Market, Statement of Operations, Fiscal Years 2003–2007 (in thousands, except per share data)

	FISCAL YEAR				
	2007	2006	2005	2004	2003
Sales	$6,591,773	$5,607,376	$4,701,289	$3,864,950	$3,148,593
Cost of goods sold and occupancy costs	4,295,170	3,647,734	3,052,184	2,523,816	2,070,334
Gross profit	2,296,603	1,959,642	1,649,105	1,341,134	1,078,259
Direct store expenses	1,711,229	1,421,968	1,223,473	986,040	794,422
Store contribution	585,374	537,674	425,632	355,094	283,837
General and administrative expenses	217,743	181,244	158,864	119,800	100,693
Pre-opening and relocation costs	70,180	37,421	37,035	18,648	15,765
Operating income	297,451	319,009	229,733	216,646	167,379
Interest expense, net	(4,208)	(32)	(2,223)	(7,249)	(8,114)
Investment and other income	11,324	20,736	9,623	6,456	5,593
Income before income taxes	304,567	339,713	237,133	215,853	164,858
Provision for income taxes	121,827	135,885	100,782	86,341	65,943
Net income	$ 182,740	$ 203,828	$ 136,351	$ 129,512	$ 98,915
Basic earnings per share	$ 1.30	$1.46	$ 1.05	$ 1.06	$ 0.84
Weighted average shares outstanding	140,088	139,328	130,090	122,648	118,070
Diluted earnings per share	$ 1.29	$ 1.41	$ 0.99	$ 0.99	$ 0.79
Weighted average shares outstanding, diluted basis	141,836	145,082	139,950	135,454	130,660
Dividends declared per share	$ 0.87	$2.45	$ 0.47	$ 0.30	—

Source: Whole Foods Market, 2007 10-K report, p. 25.

and unexpectedly low 0.8 percent in 2008 versus a robust 8.2 percent in 2007; however, much of the sluggish sales growth was at the former Wild Oats stores rather than at stores that Whole Foods had opened—comparable store sales growth was 5 percent at Whole Foods stores (but this was still well below the 10.9 percent average annual sales growth increases that Whole Foods had realized in the 2003–2007 period). During the July–September 2008 period, sales at the 55 Wild Oats stores that remained open (45 had been rebranded as Whole Foods stores) were $159.3 million and sales at these stores had grown at 4.6 percent during September 2008.

On July 29, 2008, the United States Court of Appeals for the District of Columbia reversed the lower court order allowing Whole Foods' acquisition of Wild Oats to go forward and directed the U.S. District Court to reopen the proceedings for further evidentiary hearings. Separately, the Federal Trade Commission had reopened its administrative action challenging Whole Foods acquisition of Wild Oats. The administrative case was scheduled to go to trial in February 2009. Whole Foods was vigorously contesting the FTC's administrative case.

In August 2008, Whole Foods announced that planned new store openings for 2009 would be reduced. While it was unclear how much flexibility Whole Foods had to back out of signed leases or revise the lease terms for the 70 new stores that had been scheduled to open in 2009 and 2010, it had so far been able to terminate the leases for 13 of its planned new store openings at a cost of $5.5 million. In addition, Whole Foods

Exhibit 10

Whole Foods Market, Consolidated Balance Sheet, Fiscal Years 2006–2007 (in thousands)

	YEAR ENDING	
	SEPTEMBER 30, 2007	SEPTEMBER 24, 2006
Assets		
Current assets:		
Cash and cash equivalents	—	$ 2,252
Short-term investments	—	193,847
Restricted cash	2,310	60,065
Proceeds receivable from store divestitures	165,054	—
Accounts receivable	105,209	82,137
Merchandise inventories	288,112	203,727
Deferred income taxes	40,402	48,149
Prepaid expenses and other current assets	66,899	33,804
Total current assets	667,986	623,981
Property and equipment, net of accumulated depreciation and amortization	1,666,559	1,236,133
Goodwill	668,850	113,494
Intangible assets, net of accumulated amortization	97,683	34,767
Deferred income taxes	104,877	29,412
Other assets	7,173	5,209
Total assets	$3,213,128	$2,042,996
Liabilities and Shareholders' Equity		
Current liabilities:		
Current installments of long-term debt and capital lease obligations	$ 24,781	$ 49
Accounts payable	225,728	121,857
Accrued payroll, bonus, and other benefits due team members	181,290	153,014
Dividends payable	25,060	—
Other current liabilities	327,657	234,850
Total current liabilities	784,516	509,770
Long-term debt and capital lease obligations, less current installments	736,087	8,606
Deferred rent liability	152,552	120,421
Other long-term liabilities	81,169	56
Total liabilities	1,754,324	638,853
Shareholders' equity: Common stock, no par value, 300,000 shares authorized; 143,787 and 142,198 shares issued; 139,240 and 139,607 shares outstanding in 2007 and 2006, respectively	1,232,845	1,147,872
Common stock in treasury, at cost	(199,961)	(99,964)
Accumulated other comprehensive income	15,772	6,975
Retained earnings	410,198	349,260
Total shareholders' equity	1,458,804	1,404,143
Commitments and contingencies		
Total liabilities and shareholders' equity	$3,213,128	$2,042,996

Source: Whole Foods Market, 2007 10-K report, p. 41.

Exhibit 11

Whole Foods Market, Selected Cash Flow Data, Fiscal Years 2005–2007 (in thousands)

	2007	2006	2005
Net cash provided by operating activities	$ 398,603	$ 452,664	$ 410,819
Cash flows from investing activities			
Development costs of new store locations	(389,349)	(208,588)	(207,792)
Other property, plant and equipment expenditures	(140,333)	(131,614)	(116,318)
Purchase of available-for-sale securities	(277,283)	(555,095)	—
Sale of available-for-sale securities	475,625	362,209	—
Payment for purchase of acquired entities, net of cash acquired	(596,236)	—	—
Other items	32,595	(36,167)	1,868
Net cash used in investing activities	$(894,981)	$(569,255)	$(322,242)
Cash flows from financing activities			
Dividends paid	$ (96,742)	$(358,075)*	$ (54,683)
Issuance of common stock	54,383	222,030	85,816
Purchase of treasury stock	(99,997)	(99,964)	—
Excess tax benefit related to exercise of team member stock options	12,839	52,008	—
Proceeds form long-term borrowing	717,000	—	—
Payments on long-term debt and capital lease obligations	(93,357)	(5,680)	(5,933)
Net cash provided by (used in) financing activities	$ 494,126	$(189,681)	$ 25,200
Other cash flow data			
Cash and cash equivalents at beginning of year	$ 2,252	$ 308,524	$ 194,747
Cash and cash equivalents at end of year	—	2,252	308,524
Net change in cash and cash equivalents	(2,252)	(306,272)	113,777
Interest paid	4,561	607	1,063
Federal and state income taxes paid	152,626	70,220	74,706

*Includes cash outlays for a special one-time dividend of $4.00 per share that was paid just prior to a 2-for-1 stock split in early 2006.
Source: Whole Foods Market, 2007 10-K report, p. 44.

announced that quarterly dividend payments would be suspended indefinitely. The company had cash of about $30 million and about $100 million available on existing lines of credit as of November 2008; in recent quarters, Whole Foods' capital expenditures for store expansion had exceeded its cash flows from operations, pushing total debt to $929 million. To bolster its financial position and provided needed funding for opening additional stores and revamping former Wild Oats stores, Whole Foods had recently arranged to sell $425 million of preferred stock to private equity investors, which equated to an ownership interest of 17 percent in the event the private equity investors exercised rights to convert their preferred stock into common stock.

Competitors

The food retailing business was intensely competitive. The degree of competition Whole Foods faced varied from locality to locality, and to some extent from store location to store location within a given locale. Competitors included local, regional, and national supermarkets, along with specialty grocery stores and health and natural foods stores. Most supermarkets offered at least a limited selection of natural and organic foods, and some had chosen to expand their offerings aggressively. Whole Foods' executives had said it was to the company's benefit for conventional supermarkets to offer natural and organic foods for two reasons: first, it helped fulfill the company's mission of improving the health and well-being of people and the planet and, second, it helped create new customers for Whole Foods by providing a gateway experience. They contended that as more people were exposed to natural and organic products, they were more likely to become Whole Foods customers because Whole Foods was the category leader for natural and organic products, offered the largest selection at competitive prices, and provided the most informed customer service.

Whole Foods Market's two biggest competitors in the natural foods and organics segment of the food retailing industry were Wild Oats Markets (until its 2007 acquisition by Whole Foods) and Fresh Market. Another competitor with some overlap in products and shopping ambience was Trader Joe's. Supervalu/Save-a-Lot, the sixth largest supermarket chain in North America (see Exhibit 2), had begun an initiative to launch a chain of small natural and organic foods stores called Sunflower Markets.

WildO atsM arket

Prior to being acquired by Whole Foods in August 2007, Wild Oats Market ranked second behind Whole Foods in the natural foods and organics segment and was Whole Foods' biggest and closest competitor in terms of merchandise mix, product offerings, store ambience, and target clientele. The company's 109 stores in 23 states and British Columbia, Canada, operated under four names (Wild Oats Natural Marketplace, Henry's Farmer's Market, Sun Harvest, and Capers Community Markets) and generated combined sales of about $1.2 billion. Mike Gilliland, a cofounder of Wild Oats and its original CEO, had gone on an aggressive acquisition streak during the late 1990s to expand Wild Oats' geographic coverage. But Gilliland's acquisition binge piled up extensive debt and dropped the company into a money-losing position with too many stores, a dozen different store names, a dozen different ways of operating, and inconsistent product selection and customer service from one location to another.

When Perry Odak, formerly the CEO of Ben & Jerry's Homemade until it was acquired by Unilever in 2000, joined the company in 2001, he streamlined operations, closed 28 unprofitable stores, cut prices, trimmed store staffing by 100 employees, and launched a new, smaller prototype store with a heavier emphasis on fresh food. Merchandising and marketing were revamped. The strategy was to draw in more "crossover" shoppers with lower-priced produce, meat, and seafood and raise the average customer purchase at checkout above the current $19 level. When this strategy produced only mixed results, Odak over the next several years tried a series of different strategic initiatives—accelerating new store openings, remodeling a number of existing stores, changing store layouts, expanding fresh produce selections, offering more private-label products, making efficiency improvements in distribution and store operations, and tinkering with the product mix and product selection. But none of Odak's initiatives delivered the hoped-for improvements in profit margins and company profitability, although sales did grow from $969 million in 2003 to $1.2 billion in 2006–2007. Wild Oats recorded a net loss of $43.9 million in 2001, net income of $5.1 million in 2002, net income of $1.6 million in 2003, a net loss of $40.0 million in 2004, net income of $3.2 million in 2005, and a net loss of $16.6 million in 2006.

While both Whole Foods and Wild Oats had stores in some of the same urban areas, for the most part their stores were not in the same neighborhoods. Wild Oats' latest stores were 22,000 to 24,000 square feet and featured a grocery-store layout (in which produce, dairy, meat, seafood, and baked goods were around the perimeters of the store), an expanded produce section at the front of the store, a deli, a sushi bar, a juice and java bar, a reduced selection of canned and packaged items, and store-within-a-store sections for supplements and specialty personal care products.

Fresh Market

Fresh Market, headquartered in Greensboro, North Carolina, was a family-owned 77-store chain operating in 17 states in the Southeast and the Midwest. Founded by Ray Berry, a former vice president with Southland Corporation who had responsibility over some 3,600 7-Eleven stores, the first Fresh Market store opened in 1982 in Greensboro. Berry's concept was to develop a small neighborhood store with the feel and atmosphere of an open European-style market that was service-oriented and focused on perishable goods (particularly fresh produce and meats and seafood displayed in glass-front refrigerated cases). All fixtures and display pieces were purchased used, as the store was financed entirely with the family's savings. After the Greensboro store, which had low-level lighting and classical music playing in the background, proved to be a hit with customers, Berry began to open similar stores in other locales. During the 1982–2000 period, Fresh Market's sales revenues grew at a 25.2 percent compound rate, reaching $193 million in 2000; revenues were an estimated $350 million in 2007. The company had almost 7,000 employees in early 2008. Management planned to open 15–20 new stores annually. Expansion was funded by internal cash flows and bank debt. Financial data were not available because the company was privately owned, but Fresh Market's profitability was believed to be above the industry average.

Fresh Market's product line included meats; seafood; 300 fresh produce items (including a growing organic selection); fresh-baked goods; prepared foods; 40 varieties of coffees; a selection of grocery and dairy items; bulk products; cheeses; deli items (including rotisserie meats, sandwiches, wraps, and signature soups); wine and beer; and floral and gift items. Fresh Market stores were typically in the 18,000- to 22,000-square-feet range and were located in neighborhood shopping areas near educated, high-income residents. Newer stores had an open-air design that evoked "old-world European charm, artful sophistication, old-fashioned retail sentiment, and a warm and friendly atmosphere." Warm lights, classical background music, and terra-cotta-colored tiles made Fresh Market stores a cozier place to shop than a typical supermarket.

Aside from store ambience, Fresh Market differentiated itself from natural foods stores and traditional supermarkets with what management considered as superlative service; attractive fresh produce displays; appealing fresh meat and seafood selections; and "upscale grocery boutique" items such as pick-and-pack spices, gourmet coffees, chocolates, hard-to-get H&H bagels from New York City, Ferrara's New York cheesecake, fresh Orsini parmesan cheese, and Acqua della Madonna bottled water; and an extended selection of olive oils, mustards, bulk products (granolas, nuts, beans, dried fruits, spices, and snack mixes), wine, and beer. Stores also stocked a small assortment of floral items and gifts (cookbooks, gift cards, baskets, cutting boards, and gift baskets) and a bare lineup of general grocery products. The product line emphasized variety, freshness, and quality. Each department had at least one employee in the area constantly to help shoppers—the idea was to force interaction between store employees and shoppers. From time to time, stores had cooking classes, wine tastings, and food sampling events. Fresh Market sponsored an annual fund-raiser for the Juvenile Diabetes Research Foundation called the Root Beer Float.

Stores had 75–100 employees, resulting in labor costs about double those of supermarket chains. All full-time employees were eligible immediately upon hire to enroll in a medical, dental, and life insurance plan. After 90 days, eligible full-time employees were offered additional benefits that included domestic partner medical and dental coverage, short- and long-term disability insurance, holiday bonuses, employee discounts, and a 401(K) plan with 50 percent company matching of employee contributions. Immediately upon hire, all part-time employees were eligible to enroll for medical, dental, and life insurance.

TraderJ oe's

Based in Pasadena, California, Trader Joe's was a specialty supermarket chain with more than 315 stores in 22 states (Arizona, California, Connecticut, Delaware, Georgia, Illinois, Indiana, Maryland, Massachusetts, Michigan, Missouri, Nevada, New Jersey, North Carolina, New Mexico, New York, Ohio, Oregon, Pennsylvania, Virginia, Washington, and Wisconsin). Management described the company's mission and business as follows:

> At Trader Joe's, our mission is to bring our customers the best food and beverage values and the information to make informed buying decisions. There are more than 2,000 unique grocery items in our label, all at honest everyday low prices. We work hard at buying things right: Our buyers travel the world searching for new items and we work with a variety of suppliers who make interesting products for us, many of them exclusive to Trader Joe's. All our private label products have their own "angle," i.e., vegetarian, Kosher, organic or just plain decadent, and all have minimally processed ingredients.
>
> Customers tell us, "I never knew food shopping could be so much fun!" Some even call us "The home of cheap thrills!" We like to be part of our neighborhoods and get to know our customers. And where else do you shop that even the CEO, Dan Bane, wears a loud Hawaiian shirt?
>
> Our tasting panel tastes every product before we buy it. If we don't like it, we don't buy it. If customers don't like it, they can bring it back for a no-hassle refund.
>
> We stick to the business we know: good food at the best prices! Whenever possible we buy direct from our suppliers, in large volume. We bargain hard and manage our costs carefully. We pay in cash, and on time, so our suppliers like to do business with us.
>
> Trader Joe's Crew Members are friendly, knowledgeable and happy to see their customers. They taste our items too, so they can discuss them with their customers. All our stores regularly cook up new and interesting products for our customers to sample.[22]

Plans called for ongoing development and introduction of new, one-of-a-kind food items at value prices, and continued expansion of store locations across the country.

Prices and product offerings varied somewhat by region and state. Customers could choose from a variety of baked goods, organic foods, fresh fruits and vegetables, imported and domestic cheeses, gourmet chocolates and candies, coffees, fresh salads, meatless entrées and other vegan products, low-fat and low-carbohydrate foods, frozen fish and seafood, heat-and-serve entrées, packaged meats, juices, wine and beer, snack foods, energy bars, vitamins, nuts and trail mixes, and whatever other exotic items the company's buyers had come upon. About 10–15 new, seasonal, or one-time-buy items were introduced each week. Products that weren't selling well were dropped. Trader Joe's had recently worked with its vendors to remove genetically modified ingredients from all of its private-label products. It had also discontinued sale of duck meat because of the cruel conditions under which ducks were grown.

Stores were open, with wide aisles, appealing displays, cedar plank walls, a nautical decor, and crew members wearing colorful Hawaiian shirts. Because of its combination of low prices, an emporium-like atmosphere, intriguing selections, and friendly service, customers viewed shopping at Trader Joe's as an enjoyable experience. The company was able to keep the prices of its unique products attractively low (relative to those at Whole Foods, Fresh Market, and Wild Oats) partly because its buyers were always on the lookout for exotic items they could buy at a discount (all products had to pass a taste test and a cost test) and partly because most items were sold under the Trader Joe's label.

Sunflower Farmers Markets

Sunflower Markets, out to establish a discount niche in organic and natural foods, entered the market in 2003 with four stores—two in Phoenix, one in Albuquerque, and one in Denver.[23] As of 2008, the company, based in Boulder, Colorado, had 14 stores in Arizona, Colorado, Nevada, and New Mexico and a distribution center in Phoenix. Sunflower's strategy borrowed from concepts employed by Trader Joe's and small farmer's-market-type stores. The company's mission statement described its four-pronged strategic approach:

- **We Will Always Offer the Best Quality Food at the Lowest Prices in Town.** "Better-than-supermarket quality at better-than-supermarket prices" is our motto.
- **We Keep Our Overhead Low.** No fancy fixtures or high rent. No corporate headquarters . . . just regular people, like you, looking for the best deals we can find.
- **We Buy Big.** We source directly, we pay our vendors quickly, and we buy almost everything by the pallet or truckload. That buying power means big savings for you!
- **We Keep It Simple.** We don't charge our vendors "slotting allowances" or shelf space fees. Just honest-to-goodness negotiating for the lowest possible price and we pass the savings on to you.

The company's tagline was "Serious Food . . . Silly Prices." According to founding partner Mark Gilliland, "The last thing we want to be is another wanna-be Whole Foods." Gilliland was formerly the founder and president of Wild Oats but was forced out when his aggressive expansion strategy put Wild Oats in a financial bind. Gilliland's ambitions for Sunflower were to have 50 locations in 2013 and become a company with annual sales of $500 million. In late 2007, Sunflower raised $30 million in equity financing from PCG Capital Partners to fund its store expansion initiative; plans called for opening about eight new locations annually.

Sunflower Farmers Market stores ranged from 25,000 to 27,000 square feet and had a warehouse-like atmosphere, with no customer service except for checkout personnel. Stores stocked about 5,000 different items, a number of which were one-of-a-kind products purchased in large lots from brokers. The product focus was on organic, natural, and minimally processed food items. Pallets of goods were placed wherever there was floor space available. Each store stocked fresh produce, meats and seafood, cereals, nutrition bars, health drinks, pastas, frozen meals, trail mixes, coffee, nuts, candy, salads, cheeses, breads, vitamins, supplements, natural remedies, medications, soaps, shampoos, and books. Some stores had food bars with live chefs. Each store had a weekly sales flyer, and Wednesdays were promoted as "Double Ad Day" because the previous week's ad prices also overlapped with the current weekly ad prices (which began on Wednesday); shoppers could thus find virtually twice the amount of items on sale throughout the store on Wednesdays. Stores also served the community by organizing activities, lectures, and events that emphasized the value of good nutrition and a healthy lifestyle.

Fresh & Easy Neighborhood Markets

In 2007, a new chain, Fresh & Easy Neighborhood Market, emerged as a competitor in the natural and organic segment of the retail grocery industry. Fresh & Easy was a newly established subsidiary of British supermarket giant Tesco, the world's third largest retailer (sales of £51.86 billion for fiscal year ending February 23, 2008, equivalent to about $95 billion). Tesco did extensive research on 60 American families and had numerous focus groups in California provide comments on store prototypes before opening its first 21 stores in Phoenix, followed quickly by an additional 38 stores in Las Vegas, San Diego, and Los Angeles. Some of the stores were located in low-income central-city neighborhoods, while others were adjacent to medium- and upper-income residential areas. Tesco's ambitious growth strategy called for opening Fresh & Easy locations at the rate of 3 per week, with 200 stores open by February 2009 and as many as 500 stores by 2011. The company opened an 820,000-square-foot distribution center (big enough to supply about 400 stores) in a Los Angeles suburb that was used both to create and package prepared foods and to supply area stores; a warehouse for northern California was being planned for when store expansion moved northward.

The Fresh & Easy concept called for stores to be in readily accessible neighborhood locations; have about 10,000 square feet of shopping space (about the size of an average Walgreen's); stock around 3,500 items (versus about 60,000 at a typical supermarket); and convey a theme of fresh, wholesome, and easy-to-prepare foods in a convenient and pleasant setting. Product offerings ranged from gourmet items to everyday staples and included natural and organic foods; fruits and vegetables; meats, fish, and poultry; and a selection of prepared foods and grab-and-go products—all intended to convey a theme of fresh, wholesome, and easy to prepare. About 45 percent of the products on the shelves were house-branded Fresh & Easy items—one of the biggest-selling private-label items was a $1.99 bottle of Fresh & Easy "Big Kahuna" Australian wine (an idea said to be an imitation of Trader Joe's "Two-Buck Chuck" wine offering).[24] Other key features of Fresh & Easy stores included:

- Low prices (around 20–25 percent below traditional supermarkets and on a par with the prices at WalmartS upercenters).
- Locally sourced and mostly packaged fresh produce with expiration dates.
- Wide aisles and simple store layouts.
- Low shelves that allowed shoppers to see all across the store.
- Alls elf-checkout.
- Energy-efficient store designs, lighting, and equipment (and the 820,000-square-foot distribution center had the largest solar panel roof in California).
- Most Fresh & Easy brand products, particularly prepared foods, were packaged so shoppers could see what was inside.
- A taste-before-you-buy policy where shoppers were encouraged to take almost any product to the "Kitchen Table" area of the store, where a staff person would open it or cook it and dole out samples.

However, in April 2008, top executives at Fresh & Easy announced that the company would put a three-month hold on further new store openings "to kick the tires, smooth out any wrinkles and make some improvements customers have asked for."[25] Management had already corrected a problem of stores frequently running out of certain items and responded to unexpectedly high demand for prepared foods by adding more than 100 new selections. A flyer campaign backed by the United Food and Commercial Workers Union (which represented workers at competing supermarket chains) had cast doubts about the freshness and safety of the meat and produce sold at Fresh & Easy stores (where the workforce was nonunion)—the flyers directed readers to a union-produced Web site with links to news articles detailing instances in Europe where Tesco supermarkets were found to be selling old or expired food products.

But there was also thought to be a more fundamental strategic issue about whether the Fresh & Easy concept of offering a limited selection of organic and natural foods at relatively cheap prices was really working. One analyst estimated that weekly sales at Fresh & Easy stores had only been about $170,000 instead of the projected $200,000.[26] A research report by another analyst was considerably more downbeat, suggesting that weekly sales could be averaging as little as $60,000.[27] Skeptics of the Fresh & Easy format believed that health-conscious food shoppers could find a far wider and more appealing selection at Whole Foods stores (and to a lesser extent at Trader Joe's), and the shopping ambience was far superior at both Whole Foods and Trader Joe's. Inexpensive packaged foods were commonplace at supermarkets and full-range superstores.

However, bullish observers saw the Fresh & Easy concept of trying to meld quality, low price, and convenience as a promising opportunity that could fill a big hole in the U.S. market. One very bullish retail analyst had gone out on a limb and projected that Fresh & Easy could have 5,000 U.S. stores and annual sales of $60 billion by 2020, making it one of the top 10 U.S. grocers.[28] And Tesco was widely viewed as a formidable retailer with ample resources to fine-tune Fresh & Easy's business concept and strategy and to eventually generate a return on its $700-million-plus investment in Fresh & Easy.

In commenting on the Fresh & Easy venture in the United States, Tesco CEO Sir Terry Leahy said, "Clearly, it is high risk. If it fails it's embarrassing. . . . If it succeeds then it's transformational."[29] In April 2008, Leahy announced that while Tesco expected to report losses of about $200 million in 2008 on its launch of Fresh & Easy stores in Arizona, California, and Nevada because of start-up expenses, sales were "ahead of budget" and the best-performing stores were exceeding $20 in sales per square foot per week—a typical new grocery store in the United States was said to average $9 to $10 in sales per square foot during the first year of operations.[30] He indicated that the company planned to have 200 Fresh & Easy stores open in the United States by mid-2009 and would begin releasing sales numbers for Fresh & Easy stores in September2008.

IndependentN aturalan d Health Food Grocers

In 2005, there were approximately 14,000 small, independent retailers of natural and organic foods, vitamins/supplements, and beauty and personal care products. Most were single-store, owner-managed enterprises serving small to medium-sized communities and particular neighborhoods in metropolitan areas. Combined sales of the 14,000 independents were in the $18 billion range in 2007. Two other vitamin/supplement chains, General Nutrition and Vitamin World, dominated the vitamin/supplement segment with about 7,500 store locations; vitamin/supplement chains were an alternative source for many of the products that Whole Foods stocked in the vitamin/supplement section of its stores. Most of the independent stores had less than 2,500 square feet of retail sales space and generated revenues of less than $1 million annually, but there were roughly 850 natural foods and organic retailers with store sizes exceeding 6,000 square feet and sales of between $1 million and $5 million annually.

Product lines and range of selection at the stores of independent natural and health foods retailers varied from narrow to moderately broad, depending on a store's market focus and the shopper traffic it was able to generate. Inventories at stores under 1,000 square feet could run as little as $10,000, while those at stores of 6,000 square feet or more often ranged from $400,000 to $1,200,000. Many of the independents had some sort of deli or beverage bar, and some even had a small dine-in area with a limited health food menu. Revenues and customer traffic at most independent stores were trending upward, reflecting growing buyer interest in natural and organic products. Most independent retailers had average annual sales per square foot of store space of $200 (for stores under 2,000 square feet) to as much as $470 (for stores greater than 6,000 square feet)—Whole Foods' average was over $850 per square foot in 2007 (excluding the newly acquired Wild Oatss tores).[31]

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Case 3

Competition in the Golf Equipment Industry in 2009

John E. Gamble
University of South Alabama

It is not known with certainty when the game of golf originated, but historians believe it evolved from ball and stick games played throughout Europe in the Middle Ages. The first known reference to golf in historical documents was a 1452 decree by King James II of Scotland banning the game. The ban was instituted because King James believed his archers were spending too much time playing golf and not enough time practicing archery. King James III and King James IV reaffirmed the ban in 1471 and 1491, respectively, but King James IV ultimately repealed the ban in 1502 after he himself became hooked on the game. The game became very popular with royalty and commoners alike, with the Archbishop of St. Andrews decreeing in 1553 that the local citizenry had the right to play on the links of St. Andrews and King James VI declaring in 1603 that his subjects had the right to play golf on Sundays.

The first known international golf tournament was played in Leith, Scotland, in 1682 when Scotsmen George Patterson and James VII prevailed over two Englishmen. By the 1700s golf had become an established sport in the British Isles, complete with golfing societies, published official rules, regularly held tournaments, full-time equipment manufacturers, and equipment exports from Scotland to the American Colonies. The links of St. Andrews became a private golf society in 1754 and was bestowed the title of Royal & Ancient Golf Club of St. Andrews by King William IV in 1834. The first golf society in the United States was founded in Charleston, South Carolina, in 1786.

In the United States, golf was a game that interested primarily the wealthy until the arrival of televised tournaments in the 1950s and 1960s featuring the charismatic PGA Tour players Arnold Palmer, Gary Player, and Jack Nicklaus. Increased public awareness, rising household incomes, and a rise in the number of public golf courses helped golf become a game enjoyed by more than 27 million Americans by the late 1990s. Perhaps the greatest contributor to the golf's growth was the series of technological innovations in golf club design that made the game a little easier to play. The innovations in clubhead design by equipment manufacturers such as Callaway Golf, Ping Golf, and TaylorMade Golf gave golfers of all skill levels added distance and accuracy and helped equipment sales grow to $2.9 billion by 2007.

Even though golf equipment industry sales at on-course and off-course golf shops totaled nearly $2.8 billion in 2008, the industry was in the midst of its worst-ever crisis in 2009. Equipment industry revenues had begun to decline as growth in the number of golfers stalled and rules put in place by golf's governing organizations to limit innovation in golf clubs had forced manufacturers to rely more on price to increase volume. In addition, the U.S recession that began in December 2007 and continued into

2009 had placed many industries in peril, but left industries relying on discretionary spending badly battered. Rounds played had not grown appreciably between 2004 and 2007 and had declined by 1.8 percent during 2008 as Americans began shifting discretionary income from spending to savings. Sales of golf equipment declined by 5.7 percent during 2008 and it appeared that 2009 industry sales would decline by an additional 15 percent to 20 percent. The effects of technological limitations imposed by golf's governing organizations, a decline in the number of golfers, and the worst economic conditions since the early 1980s had converged to force senior managers of the leading golf equipment manufacturers to rethink their strategies. Whatever new strategies that might unfold would have to stand up under the pressure of a possible protracted recession. Golf equipment retail sales, units sold, and average selling price by product category for 1997–2008 are presented in Exhibit 1.

Exhibit 1

Retail Value, Units Sold, and Average Selling Price of Golf Equipment Sold by U.S. On-Course and Off-Course Pro Shops, 1997–2008 (retail value dollar amounts and units in millions)

DRIVERS AND WOODS

YEAR	RETAIL VALUE (in millions)	UNITS SOLD (in millions)	AVERAGE SELLING PRICE
1997	$ 676.8	2.93	$ 231
1998	601.1	2.81	214
1999	583.8	2.91	201
2000	599.1	2.94	204
2001	626.6	2.99	210
2002	608.7	3.09	197
2003	660.4	3.28	201
2004	654.1	3.56	184
2005	792.2	4.76	166
2006	883.3	5.12	172
2007	877.7	5.03	174
2008	772.2	4.61	167

IRONS

YEAR	RETAIL VALUE (in millions)	UNITS SOLD (in millions)	AVERAGE SELLING PRICE PER CLUB
1997	$ 533.4	7.12	$ 75
1998	485.4	6.87	71
1999	447.9	6.97	64
2000	475.3	7.14	67
2001	459.3	7.17	64
2002	456.4	7.42	62
2003	461.4	7.66	60
2004	482.6	8.06	60
2005	534.3	8.26	65
2006	570.7	8.35	68
2007	579.5	8.22	71
2008	544.5	7.61	72

Exhibit 1 (continued)

PUTTERS

YEAR	RETAIL VALUE (in millions)	UNITS SOLD (in millions)	AVERAGE SELLING PRICE
1997	$ 142.1	1.70	$ 83
1998	150.3	1.68	89
1999	160.1	1.68	95
2000	161.5	1.67	97
2001	167.2	1.65	101
2002	184.3	1.65	111
2003	195.2	1.60	122
2004	188.6	1.58	120
2005	188.4	1.56	121
2006	193.8	1.53	127
2007	190.0	1.46	130
2008	182.7	1.34	137

WEDGES

YEAR	RETAIL VALUE (in millions)	UNITS SOLD (in millions)	AVERAGE SELLING PRICE
1997	$ 67.6	0.78	$ 86
1998	64.3	0.79	82
1999	65.0	0.81	80
2000	68.3	0.82	83
2001	69.4	0.82	85
2002	71.2	0.83	85
2003	77.0	0.88	87
2004	79.3	0.93	86
2005	87.5	0.99	89
2006	93.9	1.03	91
2007	95.6	1.07	90
2008	100.4	1.09	92

GOLF BALLS

YEAR	RETAIL VALUE (in millions)	UNITS SOLD (in million dozens)	AVERAGE SELLING PRICE PER DOZEN
1997	$ 458.7	19.97	$ 22.97
1998	487.4	20.06	24.30
1999	518.1	20.46	25.32
2000	530.8	20.80	25.52
2001	555.6	21.32	26.06
2002	529.9	20.81	25.46
2003	496.4	19.85	25.01
2004	506.3	19.98	25.34
2005	536.0	20.39	26.29
2006	539.0	20.45	26.35
2007	552.3	20.99	26.31
2008	536.3	19.87	26.98

continued

Exhibit 1 (continued)

FOOTWEAR

YEAR	RETAIL VALUE (in millions)	UNITS SOLD (in million pairs)	AVERAGE SELLING PRICE
1997	$ 214.3	2.48	$ 86
1998	204.3	2.43	84
1999	206.9	2.47	84
2000	220.8	2.52	88
2001	217.8	2.57	85
2002	211.7	2.68	79
2003	217.1	2.82	77
2004	234.4	3.00	78
2005	245.2	3.15	78
2006	257.7	3.24	80
2007	275.5	3.42	81
2008	281.9	3.35	84

GLOVES

YEAR	RETAIL VALUE (in millions)	UNITS SOLD (in million dozens)	AVERAGE SELLING PRICE (PER UNIT)
1997	$ 156.7	1.28	$ 12.23
1998	160.6	1.28	12.56
1999	161.6	1.30	12.46
2000	165.4	1.32	12.53
2001	169.2	1.34	12.61
2002	163.7	1.34	12.26
2003	157.1	1.29	12.16
2004	159.3	1.32	12.11
2005	164.0	1.12	12.22
2006	168.4	1.13	12.45
2007	174.9	1.17	12.46
2008	172.2	1.13	12.73

GOLF BAGS

YEAR	RETAIL VALUE (in millions)	UNITS SOLD (in millions)	AVERAGE SELLING PRICE
1997	$ 171.8	1.37	$ 126
1998	165.6	1.32	125
1999	165.4	1.32	125
2000	165.1	1.31	126
2001	163.2	1.32	124
2002	153.4	1.32	116
2003	145.5	1.32	111
2004	146.8	1.34	110
2005	150.7	1.39	109
2006	158.5	1.41	112
2007	165.8	1.43	116
2008	162.6	1.36	120

Source: Golf Datatech.

Exhibit 2

Participation Rates for Selected Sports and Recreational Activities, 1998–2008, Various Years (in millions)

	1998	2000	2002	2004	2006	2008
Bicycle riding	43.5	43.1	39.7	40.3	35.6	44.7
Fishing	43.6	49.3	44.2	41.2	40.6	42.2
Golf	27.5	26.4	27.1	24.5	24.4	25.6
Hunting	17.3	19.1	19.5	17.7	17.8	18.8
Running	22.5	22.8	24.7	26.7	28.8	35.9
Swimming	58.2	60.7	53.1	53.4	56.5	63.5
Tennis	11.2	10.0	11.0	9.6	10.4	12.6
Workout at fitness club	26.5	24.1	28.9	31.8	37.0	39.3

Source: National Sporting Goods Association.

IndustryC onditions in 2009

In 2008, approximately 25.6 million Americans played golf at least once per year—which was about 2 million less than the number of Americans playing golf in 1998. About 2 million Europeans played golf in 2008 and there were about 17 million golfers in Asia in 2008. About one-third of golfers were considered core golfers—those playing at least eight times per year and averaging 37 rounds per year. Industry sales were keyed to the number of core golfers since these frequent golfers accounted for 91 percent of rounds played each year and 87 percent of industry equipment sales, membership fees, and green fees. Even though core golfers might play once a week or more, only a small fraction of golfers might be confused for PGA touring professionals while on the course. The average score for adult male golfers on an 18-hole course was 96, with only 5 percent of adult male golfers regularly breaking a score of 80. The average score for adult female golfers was 108. Exhibit 2 provides the number of Americans playing golf during various years between 1998 and 2008. The exhibit also provides participation rates for other sports and recreational activities popular with adults. The number of golf rounds played for each year between 2001 and 2008 is presented in Exhibit 3.

Exhibit 3

Total Rounds of Golf Played in the United States, 2001–2008 (in millions)

YEAR	ROUNDS PLAYED (IN MILLIONS)	PERCENT CHANGE
2001	518.1	—
2002	502.4	− 3.0%
2003	494.9	− 1.5
2004	528.6	6.8
2005	528.1	− 0.1
2006	532.3	0.8
2007	529.6	− 0.5
2008	520.1	− 1.8

Source: National Golf Foundation.

LimitedO pportunities for Innovation in Clubface Design

The arrival of Tiger Woods to the PGA Tour in 1996 had inspired many to take up the game of golf, but most soon found that becoming a somewhat accomplished golfer was a highly demanding task. Developing a sound golf swing required regular instruction from a teaching professional, many hours of practice, and the patience to master all aspects of the game—driving the ball from the tee, long iron shots, short approach shots, hitting from the rough, chipping to the green, sand shots, and putting. Few adults had the leisure time to master all elements of the game simultaneously—for example, they might find they were hitting iron shots really well at a particular point in time, but were having trouble off the tee or botching chips and sand shots. Later they might be very pleased with their drives, but furious with their poor putting.

Golf equipment manufacturers had developed innovations at a rapid clip during the late 1990s and early 2000s to help make the game easier to play for recreational golfers. The size of the driver was increased to reduce the adverse effect of off-center hits, wedges were given more defined grooves to help improve accuracy on approach shots, and balls were redesigned to provide greater distance off the tee and better control on the green. The technological innovations proved to give golfers of modest skills an assist such that their bad shots were not quite so bad. The primary benefit of technologically advanced golf clubs and balls related to distance. Under no conditions would a poorly struck ball fly as far as a well-struck ball, but the loss of distance using modern equipment was not as great as what would be the case with older 1980s or early 1990s era equipment.

The advent of game improvement equipment was also a benefit to the world's elite professional golfers on the PGA Tour, the PGA European Tour, and the Ladies Professional Golf Association Tour (LPGA). The average driving distance on the PGA Tour had increased from 257 yards in 1980 to 290 yards in 2005. Also, it was not uncommon for touring professionals to hit the ball more than 320 yards off the tee and for women on the LPGA Tour to hit the ball as far as 290 yards. Tournament committees responded to the increased driving distance by lengthening the overall distance of the courses hosting professional tournaments. USGA officials believed that it was the organization's responsibility to limit golf club performance to protect historic golf courses that could not be lengthened because of space limitations. The USGA developed a Coefficient of Restitution (COR) measurement and limitation in 1998 that would defend against any "spring-like" effect that a high-tech driver clubface might deliver. The COR was calculated by firing a golf ball at a driver out of a cannon-like machine at 109 miles per hour. The speed that the ball returned to the cannon could not exceed 83 percent of its initial speed (90.47 miles per hour). The USGA called the ratio of incoming to outgoing velocity the coefficient of restitution (COR). Drivers that did not conform to the USGA 0.83 COR threshold were barred from use by recreational or professional golfers in the United States, Canada, and Mexico who intended to play by the USGA's Rules of Golf. The USGA refused to calculate handicaps for golfers who had used nonconforming equipment, but did not attempt to restrict the clubs' usage among players who did not choose to establish or maintain handicaps.

Golf club manufacturers disagreed that a "spring-like" effect could be produced by a metal golf club and believed the USGA's ruling that affected recreational as well as professional tournament golfers would discourage new golfers from taking up the game. Callaway Golf challenged the USGA's COR limitation in 2000 when it introduced for sale in the U.S. the ERC II driver with a COR of 0.86. The company's management believed that the 6–10 additional yards of carry achieved by recreational golfers using the ERC II posed no threat to the game of golf. Callaway Golf executives did concede that equipment limitations might be set for professional golfers, but saw no need to limit the performance of equipment used by recreational golfers who might gain more pleasure from hitting longer drives. Upon the announcement that Callaway Golf would make the club available to golfers in the United States, Arnold Palmer supported the company's decision by saying, "I think what Callaway is doing is just right. I have given a lot of thought to conforming and nonconforming clubs. If my daughter, who is a 100s shooter, can shoot 90 with a nonconforming driver, I can't imagine that there would be anything wrong with that."[1]

The ERC II was a failure in the United States since most core golfers did not want to purchase equipment that violated the USGA's Rules of Golf. The USGA clarified its purpose for barring products like the ERC II in 2002 by stating "the purpose of the Rules is to prevent an overreliance on technological advances rather than skill and to ensure that skill is the dominant element in determining success throughout the game."[2] Initially, the R&A chose only to place limitations on equipment used in elite competitive events, but came to an agreement with the USGA in 2006 to regulate driver performance for both professional golfers and recreational golfers. In order to arrive at a worldwide standard, the USGA scrapped the COR test for the R&A's Characteristic Time (CT) test. The CT test required that the golf ball remain in contact with the face of a driver for 239 microseconds, plus a test tolerance of 18 microseconds. Contact longer than 257 microseconds was considered evidence of a "spring-like" effect and would place a driver on the R&A's nonconforming list.

Once the USGA had successfully eliminated the possibility of a "spring-like" effect produced by a driver club face, it created additional rules regulating driver dimensions and other elements of driver performance. In 2004, the USGA ruled that driving clubs were not allowed to be larger than 5 inches by 5 inches and could not have a volume of more than 460 cubic centimeters. With clubhead size and clubface CT off limits, golf club manufacturers began to pursue innovations that would increase the clubface area capable of producing the maximum CT. Specifically, drivers offered by all golf club manufacturers produced the maximum CT rating allowed by the USGA and R&A, but the percentage of the surface area of the clubface producing the maximum CT might vary quite a bit between driver models and brands. Therefore, all club manufacturers were in a race to push the allowable CT area out to the perimeter of the clubface. This clubface performance characteristic was referred to as Moment of Inertia (MOI). Higher MOI drivers allowed golfers to hit the ball near the inside heel of the club or toward the outer toe of the club and still achieve a near-maximum driving distance. The USGA notified golf equipment manufacturers in 2005 that driver MOI had tripled over the past 15 years and, beginning in 2006, MOI would be limited to 5,900 g-cm^2 with a tolerance of 100 g-cm^2.

The USGA was also concerned about the performance of technologically advanced golf balls such as the Titleist Pro V1, which was introduced in 2000. The Pro V1, Callaway Golf Tour-i, Nike One, and a few other high-tech golf balls were designed to reduce spin when hit by a driver and increase spin when hit by a wedge during an approach shot. Low spin off the tee made the ball fly much farther than higher spinning balls, while high spin on shorter shots allowed golfers to stop the ball quickly once it hit the green. Before the development of the Pro V1, golfers were required to make a choice—low spin off the tee (increased driving distance) and low spin into the green (poor distance control on the green) or high spin off the tee (shorter driving distance) and high spin into the green (good shot-stopping ability). In June 2005, the USGA asked all golf ball manufacturers to develop prototypes of golf balls that would fly 15–25 yards shorter than current models. USGA officials asked that these prototypes be submitted for evaluation by golf's governing body.

The USGA also believed that the tremendous spin that PGA Tour golfers achieved when hitting shots into the green was partly attributable to wedge technology. The combination of soft-cover golf balls like the Pro V1, Callaway Golf Tour-i, or Nike One and the precision milled grooves of the latest-technology wedges produced ample spin to stop shots near the hole, even when hit from deep rough. The USGA ruled in August 2008 that, beginning January 2010, golf equipment manufacturers must discontinue producing wedges with sharply squared groove edges on irons and wedges. The grooves of irons and wedges produced after January 2010 were required to have rounded edges to minimize spin. Under the new rule concerning groove shape, any remaining inventory of Callaway Golf Mack Daddy, Titleist Spin Milled, or Cleveland Zip Groove wedges would have to be removed from the market after 2009.

With all of the technological advances in golf club and golf ball design, there was little evidence that it was helping golfers achieve lower scores. The average score on the PGA Tour had declined only from 71.18 in 1990 to 71.07 in 2005 and with the exception of Tiger Woods, almost none of the longest drivers on the PGA Tour were at the top of the Tour's Money List. Technology also had a minimal effect on the scores of recreational golfers. The average men's handicap maintained with the USGA had declined from 16.3 in 1993 to just 15.0 in 2005, while the average women's handicap had declined from 29.9 in 1993 to 28.0 in 2005.

In a March 2006 *PGA Magazine* article focusing on the future of golf equipment, a teaching professional and PGA member argued against the USGA's position on innovation in golf equipment:[3]

> Technology has had a wonderful impact on golf, and although we see longer drives and some lower scores on the PGA Tour, what's the harm? . . . If the average golfer enjoys the game more by playing a little better through technology, that's a plus.

A 16-year PGA professional disagreed with the entire premise behind the USGA's technology limitations by commenting:[4]

> Today's high-tech equipment isn't making any courses obsolete for the average player. Maybe technology has made some courses too short for Tiger [Woods] and players on the PGA Tour, but technology has only helped most players gain more gratification from playing the game.

When asked about what impact USGA rulings might have on the health of the game of golf, the USGA's senior communications directorc ommented:[5]

> In a nutshell, we are pleased overall with the state of our game. Growth, however, is not the yardstick by which we judge success or failure. . . . I would contend that we look at our role as one of governing the game responsibly and effectively so that all constituencies—tours, manufacturers, amateurs—enjoy a healthy climate in which to pursue a favorite and rewarding pastime that can be passed down from one generation to the next.

Decline in the Number of Golfers and Rounds Played

The decline in the number of golfers and the recent downturn in the number of rounds played were thought by industry analysts to result from a variety of factors. The overall difficulty of the game and the disappointment of many golfers that low scores didn't come quickly after taking up the sport were certainly factors in people leaving the game. A survey of golfers conducted in June 2003 by the National Golf Foundation found that limited time to practice and play golf was another closely related factor contributing to golf's decline. Golfers who were married with children were most likely to comment that job responsibilities, lack of free time, and family responsibilities prohibited them from playing golf on a more regular basis. Job responsibilities and lack of free time were also barriers to playing golf more frequently for married or single golfers who had no children. Older golfers who were either retired or who were working less than 40 hours per week were more likely to list heath concerns or injuries as a major reason for not playing golf more often. About 30 percent of survey respondents cited high golf fees as a barrier to playing more golf.

The Rise of Counterfeiting in the Golf Equipment Industry

In 2007, more than $600 billion worth of counterfeit goods were sold in countries throughout the world. Fake Rolex watches or Ralph Lauren Polo shirts had long been a problem, but by the mid-2000s counterfeiters were even making knockoffs of branded auto parts, shampoo, canned vegetables, and prescription drugs. It was estimated that 90 percent of the world's counterfeit merchandise originated in China and that counterfeit goods accounted for 15–20 percent of all products made in China. Interpol testified before U. S. Congress in 2005 that counterfeits were frequently illegally imported from China into Western countries by organized crime and terrorist groups such as al Qaeda and Hezbollah. Counterfeiting was an effective approach to funding the activities of organized crime and terrorist groups since fake brands were as profitable as drugs and there was very little risk of being prosecuted if caught.

Counterfeit clubs were a considerable threat to the industry since good counterfeits were nearly exact copies of legitimate products. The extraordinarily low prices that counterfeit clubs were offered at were too great a temptation for many bargain hunter golfers. In 2009, it was not unusual to see complete sets of new Callaway, TaylorMade, Ping, Titleist, Nike, or Cobra clubs that would retail for more than $2,000 sell on eBay or similar auction Web sites for $150 to $400. eBay sellers and others who dealt in counterfeit merchandise could purchase counterfeit sets complete with eight irons, a driver, two or three fairway woods, a putter, a golf bag, and a travel bag for as little as $100–$200 in China. Callaway Golf Company alerted visitors to its Web site to counterfeit clubs sold on eBay or other Internet sites with the warning: "A full set of authentic Callaway Golf clubs, depending on the models, will retail for $2,500–$3,000 or more. If the deal looks too good to be true, it probablyi s."[6]

The rise of counterfeiting in the golf equipment industry was attributable, to a large extent, to the decisions by golf executives to source clubheads and sometimes contract out assembly of golf clubs to manufacturers in China. Counterfeiters were able to make very accurate copies of branded golf clubs by enticing employees of contract manufacturers to steal clubhead molds that could be used to produce counterfeit clubheads. In some cases, contract manufacturers scheduled production runs after hours to produce black market clubs. Counterfeiters even copied the details of the packaging golf clubs were shipped in to better disguise the fakes. It was estimated that counterfeiters in China could produce golf clubs for less than $3 per club.

The golf equipment industry's six leading manufacturers created an alliance in December 2003 to identify and pursue counterfeiters and sellers of counterfeit clubs. TaylorMade Golf, Fortune Brands (parent of Titleist and Cobra Golf), Callaway Golf, Ping Golf, Cleveland Golf, and Nike Golf had successfully shut down many Internet auction sellers in the United States and Canada that listed counterfeit clubs and had gained cooperation from the Chinese government to confiscate counterfeit goods produced in that country. In 2008, a Chinese man was sentenced to three years and six months in jail and ordered to pay a $58,000 fine after being convicted of running an illegal operation selling counterfeit golf equipment during 2007. Chinese officials confiscated nearly 10,000 counterfeit golf clubs, accessories, and components from a Beijing counterfeiter in 2009 after evidence against the counterfeiter had been provided to the Chinese government by the golf industry anti-counterfeiting alliance.

The Recession of 2008 and 2009

The combined effect of the USGA and R&A performance limitations, the decline in the number of golfers, and international counterfeiting on the golf equipment industry was amplified by the U.S. recession that began in December 2007. A number of factors contributed to the recession, but the onset of the recession coincided with tumult in the credit and housing industries and a rapid increase in the average U.S. gasoline price, which jumped from less than $2.25 per gallon in early 2007 to more than $3.00 by year-end 2007; and to more than $4.00 per gallon in June 2008.[7] As average monthly household expenditures for gasoline hit a near-record 4.0 percent of after-tax income in April 2008, many consumers saddled with increasing payments on adjustable rate mortgages and rising monthly payments on credit card bills or other growing expenses were forced to cut back on discretionary spending.[8] Rising unemployment quickly followed scaled-back discretionary spending with the unemployment rate growing from 5 percent in April 2008 to about 6 percent by the end of summer 2008 and to 9.5 percent in June 2009.[9] Some economists, including Lawrence Summers, President Barack Obama's top economic advisor, noted that based on historical patterns the loss of jobs accompanying the 2008–2009 recession was much worse that would be expected under economic rules of thumb. For example, the economy had contracted by only 2.5 percent between the beginning of the recession in December 2007 and June 2009, but more than 6.5 million Americans had lost their jobs during that time (a number equal to 4.7 percent of total U.S. employment).[10] With more than 500,000 additional Americans losing jobs each month and no sign that the $787 billion economic stimulus package passed by the House and Senate and signed by President Obama in February 2009 was bringing an end to the recession, many U.S. consumers cut back further on discretionary purchases to boost personal savings. The U.S. personal savings rate had increased from negative or near zero savings rates between 2005 and 2007 to 6.9 percent in May 2009.[11] Falling consumer confidence and the massive spending pullback by consumers fearful of losing their jobs impacted all industries, but hit the providers of nonessential goods and services the hardest.[12]

ForcesS haping Competition in the Golf Equipment Industry

Competitive Rivalry in the Golf Equipment Industry

Competitive rivalry in the golf equipment industry centered on technological innovations as allowed by the USGA and R&A, product performance, brand image, tour exposure, and price. Product innovation, performance, image, tour exposure, and price were also the primary competitive variables at play in the golf ball segment of the industry. In 2009, most golf club manufacturers had met dimension, volume, CT, and MOI limits and were attempting to achieve differentiation in drivers by either lowering the center of gravity to increase launch angle or by offering clubs with adjustable features. For example, Nike Golf, Callaway Golf and Nickent Golf had introduced drivers utilizing square or other geometric shapes to position weight further behind the clubface to boost MOI and produce a higher launch angle. Some equipment manufacturers had looked to adjustability to differentiate their product lines from competing brands. Callaway Golf's I-Mix drivers introduced in 2008 allowed golfers to install different shafts into the driver head to produce different launch characteristics. TaylorMade's r9 and Nike's Dymo drivers utilized an interchangeable shaft that adjusted the clubhead launch angle and left/right face angle. Interchangeable and adjustable shafts were allowed under USGA rules that went into effect in January 2008 that permitted adjustable features to clubs provided that the adjustable feature was approved by the USGA during the design process.

Golf club manufacturers also relied heavily on endorsements from touring professionals to enhance their image with consumers. Most recreational golfers who watched televised golf tournaments or read golf magazines were very aware of what brands of clubs and golf balls their favorite touring professionals used. It was not at all unusual for recreational golfers to base purchase decisions on the equipment choices of successful golfers on the PGA Tour. Leading golf equipment companies had always struck endorsement deals with the game's best-known players, but the value of endorsement contracts had escalated since 2000. During the late 1990s, the PGA Tour's top-10 golfers could expect to earn between $250,000 and $400,000 annually through endorsement contracts. By 2007, the top-10 golfers on the PGA Tour all earned at least $4 million annually through endorsements and PGA Tour professionals ranked 40 to 70 on the Money List could expect anywhere from $450,000 to $800,000 in annual endorsement fees. Tiger Woods had led the PGA Tour in endorsement fees since his professional debut in 1996 when he earned over $12 million from product endorsements. Tiger Woods earned more than $80 million from endorsement contracts in 2009, which brought his career earnings from prize money, endorsements, and golf course design fees to $1 billion.

Suppliers to the Industry

Many club makers' manufacturing activities were restricted to club assembly since clubhead production was contracted out to investment casting houses located in Asia and shafts and grips were usually purchased from third-party suppliers. Casting houses like Advanced International Multitech Company in Taiwan produced clubheads to manufacturers' specifications and shipped the clubheads to the United States for assembly. In some cases, clubheads and shafts were also assembled by suppliers in China and shipped to the United States as fully assembled products ready for shipment to retailers.

Manufacturers were quite selective in establishing contracts with offshore casting houses since the quality of clubhead greatly affected consumers' perception of overall golf club quality and performance. Poor casting could result in clubheads that could easily break or fail to perform to the developers' expectations. In addition, it was important that golf equipment manufacturers perform background checks on suppliers and initiate security procedures to prevent finished clubheads and completed golf clubs from leaving the production facility and making it to the black market.

Differentiation based upon shaft performance became more important to golf club manufacturers as technological differences between brands of golf clubs decreased after the USGA limitation on clubhead size and performance was enacted. Most golf club manufacturers co-developed modestly-sized lines of proprietary shafts with companies specializing in shaft design and manufacturing. The relatively narrow line of shafts bearing the club manufacturer's name was supplemented with branded shafts produced and marketed by companies such as Aldila, UST, Fujikura, or Graphite Designs. Even though third-party branded shafts were equally available to all manufacturers, they were important in attracting sales to skilled core golfers, since these golfers might have as strong a preference for a particular shaft as for a clubhead design. For example, the purchase decision made by a low handicap golfer considering two drivers might come down to which club could be ordered with a specific shaft. Grips had yet to prove to be a point of differentiation and few golfers showed a strong preference for one brand of grip over another.

GolfE quipmentR etailers and the Distribution and Sale of Golf Equipment

Leading golf equipment manufacturers distributed their products through on-course pro shops, off-course pro shops such as Edwin Watts and Nevada Bob's, and online golf retailers such as Golfsmith.com and TGW.com. Most on-course pro shops sold only to members and carried few clubs since their members purchased golf clubs infrequently. Off-course pro shops accounted for the largest portion of retail golf club sales because they carried a wider variety of brands and marketed more aggressively than on-course shops. Off-course pro shops held an advantage over online retailers as well since golf equipment consumers could inspect clubs and try out demo models before committing to a purchase. Also, both on-course and off-course pro shops were able to offer consumers custom fitting and advice from a PGA professional or other individual with the training necessary to properly match equipment to the customer. Most consumers making online purchases had already decided on a brand and model and bought online to get a lower price or to avoid sales taxes. However, most of the top brands required online retailers to sell their equipment at the suggested retail price. Both online retailers and brick-and-mortar retailers were free to sell discontinued models at deep discounts, which was very appealing to golfers who did not mind purchasing models from the previous year.

Custom-fitting was offered by most manufacturers and large off-course pro shops with the use of specialized computer equipment. Common swing variables recorded and evaluated in determining the proper clubs for golfers included clubhead speed, launch angle of the ball, back spin on the ball, side spin on the ball, ball flight pattern, ball flight carry distance, and roll distance. Custom-fitting had become very important as golf equipment companies expanded shaft flex options. For example, the Callaway Golf I-Mix FT-9 and FT-iQ drivers could be ordered with any number of 70 different shafts produced by Aldila, Fujikura, Graffaloy, UST, Mitsubishi Rayon, Matrix, or Graphite Design shafts.

Pro shops generally chose to stock only equipment produced by leading manufacturers and did not carry less expensive, less technologically advanced equipment. Low-end manufacturers sold their products mainly through discounters, mass merchandisers, and large sporting goods stores. These retailers had no custom fitting capabilities and rarely had sales personnel knowledgeable about the performance features of the different brands and models of golf equipment carried in the store. The appeal of such retail outlets was low price, and such stores mainly attracted beginning golfers and occasional golfers who were unwilling to invest in more expensive equipment.

Profiles of the Leading Manufacturers and Marketers of Golf Equipment

CallawayG olfC ompany

Callaway Golf Company began to take form in 1983 when Ely Reeves Callaway, Jr., purchased a 50 percent interest in a Temecula, California, manufacturer and marketer of hickory shafted wedges and putters for $400,000. Ely Callaway knew from the outset that the company's prospects for outstanding profits were limited as long as its product line was restricted to reproductions of antique golf clubs. Callaway purchased the remaining 50 percent interest in the company and, in 1985, hired a team of aerospace and metallurgical engineers to design and produce the industry's most technologically advanced golf clubs. The company launched noteworthy product lines within a few years, but its revenues skyrocketed from less than $10 million to more than $500 million after its 1991 introduction of the Big Bertha stainless steel driver. The Big Bertha was revolutionary in that it was much larger than conventional wooden drivers and performed far better than wooden drivers when players made poor contact with the ball. The success of the Big Bertha driver set off a technology race in the industry, whereby Callaway Golf and its chief rivals launched innovations every 12–18 months that further improved the performance of metal drivers.

Also during Ely Callaway's tenure as CEO, the company acquired Odyssey, a leading brand of putters, in 1996 and began manufacturing and marketing golf balls in 2000. In February 2000, a survey of golf equipment company executives voted Callaway's Big Bertha driver the best golf product of the century by a two-to-one margin. The same group of executives called Ely Callaway the most influential golf trade person of the 1990s. Ely Callaway stepped down as president and CEO of the company in May 2001 after being diagnosed with pancreatic cancer. The company's performance began to decline soon after Ely Callaway's death in July 2001 and by 2003 had lost its number-one ranking in the driver and fairway wood segments of the industry.

In 2009, Callaway Golf was the second-largest seller of drivers and fairway woods. Its square geometric-shaped FT-iQ and traditional-shaped FT-9 driver lines featured titanium clubfaces, carbon composite shells and prepositioned weights that produced a draw, fade, or neutral ball path. Both the FT-iQ and the FT-9 were available with fixed shafts or any of its 70 I-Mix interchangeable shafts. The FT-9 and FT-iQ drivers were priced at $399 and $499, respectively, with a fixed shaft or $400–$700 with a single I-Mix shaft. Each additional shaft ranged from $99 to $299. Callaway Golf also produced a fixed shaft Big Bertha Diablo driver that sold for $299 and a fixed shaft Hyper X driver line that sold for $199. The company's Big Bertha Diablo fairway woods sold for $179–$199 in retail stores, its X line of fairway woods were offered at $149–$169, and its FT fairway woods carried a retail price of $249–$299.

In the years following Ely Callaway's death, the company struggled with a series of issues beyond loss of market share of its flagship driver business. The company misread the market potential for hybrid clubs, which were substitutes for low-lofted, long irons. TaylorMade's Rescue was the first hybrid to gain a widespread appeal, but almost all manufacturers raced to quickly get hybrid clubs to the market. Callaway Golf's failure to get its hybrid club to market before 2005 caused it to lose significant sales as many golfers purchased TaylorMade, Adams Golf, and Cobra hybrid clubs to replace the 2-, 3-, and 4-irons in their bags. It was estimated that 31 percent of all golfers had purchased at least one hybrid club by 2007. In 2009, Callaway Golf's X line of hybrid clubs retailed from $99–$129, while its FT line of hybrids sold for $199.

As Callaway Golf struggled with its golf club business, its golf ball start-up also failed to perform to management's expectations. The company's golf ball business had lost $90 million between 2000 and 2002 and showed little hope of providing a return on its $170 million investment in a state-of-the-art golf ball plant. In 2003, Callaway Golf Company acquired bankrupt golf ball producer Top-Flite Golf for $125 million. The Top-Flite acquisition was executed to give Callaway Golf Company the volume necessary to achieve economies of scale in golf ball production since Top-Flite was the second largest seller of golf balls in the United States with a market share of 16.3 percent. About $175 million of Top-Flite's 2002 revenues were generated from the sale of golf balls. Top-Flite's sales of Top-Flite and Hogan branded golf clubs accounted for about $75 million of the company's $250 million total revenues in 2002.

Callaway Golf's integration of Top-Flite's golf ball operations proved to be more troublesome that management expected. Top-Flite had invested little in R&D over the years and the performance of its products had fallen substantially behind that of key industry rivals. Top-Flite golf balls sold at the lowest price points in the industry and had become known among golfers as "Rock-Flite" because of their hard covers and overall poor quality. The perception of poor quality and performance caused Top-Flite's market share to fall to 6.3 percent by 2006. Callaway branded golf balls, however, had grown to account for nearly 10 percent of industry sales by 2006. Callaway Golf's Tour-i golf ball was a technological equal to Titleist's Pro V1 and was used by such touring professionals as Phil Mickelson, Stuart Appleby, Morgan Pressel, and Ernie Els.

Callaway Golf launched a broad plan to resurrect the Top-Flite brand in 2007 that included the development of a new line of D2 golf balls that included some of the innovations found in the Tour-i line of golf balls. The company supported the launch of the D2 line with the "Rock Flite is Dead" advertising campaign that acknowledged the company's past reputation for poor quality and performance. The better-performing D2 line allowed Top-Flite to add 900 retailers who had previously not considered Top-Flite to be a legitimate brand. The strong sales for the Callaway Golf's technologically advanced Tour-i golf balls and the sales gains from the D2 line helped its golf ball division record its first profitable year in 2007. Profitability in the golf ball business was also achieved by moving production from Callaway Golf's production facilities in the United States to suppliers in China. Callaway Golf had closed its Carlsbad, California, golf ball plant in 2005 and, in 2008, closed one of its two remaining golf ball plants in the United States in order to outsource a larger percentage of its golf ball production requirements. The sales of Top-Flite and Callaway Golf branded golf balls made the company the second largest seller of golf balls in 2008.

Callaway Golf's Odyssey putter line had remained a bright spot for the company since its 1996 acquisition. From quarter to quarter during the late 1990s, Odyssey and Ping shifted spots as the industry's top-selling brand of putter. However, Callaway Golf's 2001 development of the innovative Odyssey 2-Ball putter gave it a decisive lead in the putter category of the golf equipment industry. Odyssey had a

35 percent market share in the putter category of the industry in 2007. It had retained its market-leading position through the development of new models of 2-Ball putters and a variety of conventional-looking models. Most Odyssey putters sold at price points between $100 and $170, but the company had offered a Black Series of Odyssey putters in 2009 that carried an average sales price of $270. The Black Series was intended to compete against Titleist's Scotty Cameron premium line of putters and had a 1.2 percent market share in 2007.

Callaway Golf became the industry leader in the iron segment with its 2000 introduction of the X-14 series of perimeter-weighted irons. Callaway remained the leader in the iron segment of the industry between 2002 and 2008 through continued innovation in perimeter-weighted irons. Its X-16, X-18, X-20, and X-22 model lines incrementally improved the performance of the popular X-14 line. The company also produced a composite construction FT line of irons that featured a titanium face welded to a proprietary metal frame and finished with a thermoplastic urethane cavity-back insert. Callaway's X-Forged irons were designed to compete against Titleist's blade-style irons that were popular with touring pros and the most skilled recreational golfers. Callaway Golf also produced a Big Bertha line of irons that featured a low center of gravity and produced a high launch angle. The low center of gravity and high launch angle benefited many women and senior men golfers with slower than average swing speeds. Callaway Golf irons covered all price points between $600 and $1,300 per 8-club set. The company had chosen to limit its endorsement contracts to 12 PGA Tour professionals and 5 LPGA Tour professionals in 2009.

Callaway Golf Company also designed and sold a Callaway Golf footwear line and received royalties from the sale of Callaway branded golf apparel, watches and clocks, travel gear, eyewear, and golf rangefinders. Discontinued apparel, footwear, accessories, and golf club models could be purchased online at Callaway Golf's www.callawaygolfpreowned.com Web site. New models of Callaway golf clubs could be purchased online at shop.calllawaygolf.com. Order fulfillment for new clubs purchased online was made by a network of retailers who participated in Callaway Golf's Internet sales program. The company acquired uPlay, the maker of the uPro golf GPS system in 2009. Callaway's uPro GPS units retailed for $399 and were available at shop.callawaygolf.com and in on-course and off-course golf shops. A financial summary for Callaway Golf Company for the years 1997 to 2008 is presented in Exhibit 4. Exhibit 5 provides the company's revenues by product group for the period 1999 to 2008.

During the first six months of 2009, Callaway Golf's revenues had declined by 17 percent compared to the first six months of 2008. Its earnings per diluted share had declined from $0.58 in the second quarter of 2008 to $0.10 in the second quarter of 2009. A preferred equity offering during 2009 diluted second quarter 2009 earnings by $0.01 per share. The uPlay acquisition resulted in a second quarter 2009 charge of $0.05 per share.

TaylorMade-adidas Golf

TaylorMade was founded in 1979 when Gary Adams mortgaged his home and began production of his "metalwoods" in an abandoned car dealership building in McHenry, Illinois. Both touring pros and golf retailers alike were skeptical of the new club design until they found that the metal woods actually hit the ball higher and farther than persimmon woods. By 1984, TaylorMade metalwoods were the number one wood on the PGA Tour and the company had grown to be the third largest golf equipment company in the United States. The company was acquired by France-based Salomon SA in 1984, which provided the capital necessary for the company to continue to develop innovative new lines of metal woods. The company also produced irons and putters, but the majority of TaylorMade's sales were derived from high-margin drivers and fairway woods.

TaylorMade's metalwood drivers were the most technologically advanced in the industry until Callaway Golf's 1991 introduction of

Exhibit 4

Callaway Golf Company, Financial Summary, 1997–2008 (in thousands, except per share amounts)

	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Net sales	$1,117,204	$1,124,591	$1,017,907	$998,093	$934,564	$814,032	$792,064	$816,163	$837,627	$719,038	$703,060	$848,941
Operating income	84,188	90,183	37,055	17,206	(24,702)	65,855	111,060	114,317	124,727	79,909	(40,139)	209,189
Operating income as a percent of sales	8%	8%	4%	2%	−3%	8%	14%	14%	15%	11%	−6%	25%
Pretax income	101,307	88,275	34,998	14,537	(23,713)	67,883	111,671	98,192	128,365	85,497	(38,899)	213,765
Pretax income as a percent of sales	9%	8%	3%	1%	−3%	8%	14%	12%	15%	12%	−6%	25%
Net income	$ 66,176	$ 54,587	$ 23,290	$ 13,284	($ 10,103)	$ 45,523	$ 69,446	$ 58,375	$ 80,999	$ 55,322	($ 25,564)	$132,704
Net income as a percent of sales	6%	5%	2%	1%	−1%	9%	9%	7%	10%	8%	−4%	16%
Fully diluted earnings per share	$ 1.04	$ 0.81	$ 0.34	$ 0.19	($ 0.15)	$ 0.68	$ 1.03	$ 0.82	$ 1.13	$ 0.78	($ 0.38)	$ 1.85
Shareholders' equity	$ 578,155	$ 568,230	$ 577,117	$596,048	$586,317	$589,383	$543,387	$514,349	$511,744	$499,934	$453,096	$481,425

Source: Callaway Golf Company annual reports.

Exhibit 5

Callaway Golf Company's Net Sales by Product Group, 1999–2008 (in thousands)

PRODUCT GROUP	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999
Woods	$ 268.3	$ 305.9	$ 266.5	$241.3	$238.6	$252.4	$310.0	$392.9	$403.0	$429.0
Irons	308.5	309.6	288	316.5	259.1	280.7	243.5	248.9	299.9	221.3
Putters	101.7	109.1	102.7	109.3	—[1]	—[1]	—[1]	—[1]	—[1]	—[1]
Golf balls	223.1	213.1	214.8	214.7	231.3	78.4	66	54.9	34	—[2]
Accessories and other	215.6	186.9	145.9	116.3	205.6	202.5	172.6	119.5	100.8	68.7
Net Sales	$1,117.2	$1,124.6	$1,017.9	$998.1	$934.6	$814.0	$792.1	$816.20	$837.60	$719.00

[1] Net sales for putters included in Accessories and other for 1999–2004.
[2] Golf ball operations began in 2000.
Source: Callaway Golf Company annual reports

the oversized Big Bertha metal wood. During the entire decade of the 1990s, TaylorMade fell further behind Callaway Golf in the technology race, but remained runner-up in the driver segment. TaylorMade and its parent were acquired by athletic footwear and apparel company adidas in 1997 and gained the lead in the market for drivers with its 2003 introduction of its 400 cc R580 driver. The company's R580 driver was 40ccs larger than Callaway's competing Great Big Bertha II driver and matched consumers' preference for the largest possible driver. TaylorMade expanded its lead over Callaway Golf in drivers with its 2004 introduction of its r5 series and r7 Quad drivers. The r7 Quad's moveable weight technology allowed users to use a special tool to move four tungsten weights with a total weight of 48 grams to ports in various positions in the clubhead to produce whatever bias the golfer found necessary on a given day. For example, a golfer who was struggling with a low fade could move the heaviest of the four weights to the toe of the clubhead to favor a high draw. The golfer could later move the weights to a different position if he or she experienced a different ball flight on a different day. The moveable weight system allowed golfers to have a single driver that could produce six ball flight paths.

In 2009, TaylorMade's latest-generation r9 driver combined the moveable weight system with interchangeable shafts that had different settings to adjust the face angle up and down and from left to right. The adjustable face allowed golfers to further refine their ball flight path higher or lower and by 75 yards left and right. The r9 carried a retail price of $500. TaylorMade offered drivers at four different price points, with two r9 sub-models selling for $400 and $300, two r7 models that included the moveable weight system, but not having an adjustable face or interchangeable shafts, selling for $300 and $200, and three nonadjustable Burner models selling at price points of $400, $300, and $200. As of 2009, TaylorMade's management had not chosen to develop a geometric-shaped driver—having commented in 2007 that square drivers did not offer any technological advantage over traditional-shaped drivers.

TaylorMade was also the leading seller of hybrid clubs. TaylorMade introduced its Rescue line of hybrid clubs in 1999, but the clubs did not become a huge success in the marketplace until 2002. In 2009, TaylorMade Rescue hybrid clubs sold at $160–$200, while its Burner Rescue hybrids sold at a retail price of $130. TaylorMade's r9 line of fairway woods also featured adjustable shafts and moveable weights and sold for $230– $300 in retail stores. TaylorMade's r7 fairway woods sold for $130– $180 and its Burner series of fairway woods also sold for $130– $180 at retail and did not have moveable weights.

TaylorMade success in drivers and hybrid clubs had not translated to iron sales with the company never challenging Callaway Golf for market share leadership in the category. In late 2005, the company introduced its r7 irons in hopes of repeating the success of the r7 driver in irons. The r7 irons were designed much like Callaway Golf's Fusion irons and Ping Rapture V2 irons with a titanium face mounted to a steel perimeter-weighted frame. The r7 irons also featured prepositioned tungsten cartridges imbedded into the stainless steel clubhead to improve launch angles. The company also produced Burner and Tour Burner lines of perimeter-weighted irons, which competed with Callaway Golf X-22 irons, Ping i10 irons, and other perimeter-weighted irons. Its Burner Plus high trajectory irons competed with Callaway Golf Big Bertha Irons and Ping G5 and G10 irons. TaylorMade's Tour Preferred and TP MB Smoke forged irons that were targeted to low-handicap golfers and competed against Titleist irons, Callaway Golf X-Forged irons, and Ping S57 irons. In 2008, TaylorMade irons covered all price points between $600 and $1,300 for an 8-club set. TaylorMade's combined sales of all three lines of irons gave it a 15.2 percent market share in the iron category of the industry in 2007.

TaylorMade was a weak competitor in the putter category of the golf equipment industry with a 14-model product line that had long been ignored by most golfers. The company's putters carried retail prices between $100 and $230 in 2009. As was the case with putters, TaylorMade wedges were not particularly well-regarded by core golfers. The company introduced a new line of forged Z groove wedges to better compete against Cleveland, Titleist, and Callaway Golf in the wedge category, but as of 2009, had made no real headway in capturing a larger share of the market for wedges. The retail price of TaylorMade's wedges ranged from $70 to $120 in 2009.

The division's Maxfli golf ball business had produced consistently dismal results each year since its acquisition in 2002. Maxfli's Noodle sub-brand had become popular with price sensitive consumers and had sold more than 2 million dozen per year, but the Maxfli brand in total accounted for less than 5 percent of golf ball sales worldwide. TaylorMade sold the chronic money loser in 2008 to Dick's Sporting Goods, which also manufactured and marketed Slazenger and Walter Hagen branded golf equipment. At the time of the sale, Maxfli produced only one Maxfli branded golf ball model and the Noodle sub-brand. The terms of the sale allowed TaylorMade to retain the Noodle brand along with its newly introduced TaylorMade TP Red and TP Black premium-priced golf balls and lower-priced TaylorMade Burner brand of golf balls. TaylorMade had not achieved any significant market success with its TP Red, TP Black, or Burner golf balls, but expected to eventually challenge Callaway Golf and Nike for the title of runnerup to golf ball leader, Titleist.

The sales of TaylorMade's adidas branded golf apparel and golf shoes had grown at compounded annual rates of 23.3 percent and 13.5 percent, respectively, between 2004 and 2008 through the continued introduction of new styles and exposure on the professional tours by such well-known golfers and Sergio Garcia, Natalie Gulbis, Paula Creamer, and Retief Goosen. In all, TaylorMade-adidas Golf had signed endorsement contracts with 70 golfers on the men's and women's professional tours. The company's endorsement contracts called for golfers to use a TaylorMade driver and 11 other TaylorMade clubs and wear either the company's apparel or shoes during tournaments. The heavy reliance on endorsements by touring professionals made adidas the most widely worn apparel brand on the professional tours. Some of its touring staff was also compensated to use TaylorMade's TP Red or TP Black golf balls during tournaments. TaylorMade also had limited contracts with an additional 40 golfers to use TaylorMade drivers during professional tournaments. Exhibit 6 presents net sales and operating profit between 2004 and 2008 for TaylorMade-adidas Golf. The

Exhibit 6

Financial Summary for adidas Group's TaylorMade-adidas Golf Business Unit, 2004–2008 (in millions)

***TaylorMade-adidas Golf Financial Performance* (in millions)**

	2008	2007	2006	2005	2004
Net sales	€812	€804	€856	€709	€633
Operating profit	78	65	73	50	60

***Sales Contribution by Product Line* (in millions)**

	2008	2007	2006	2005	2004
Metalwoods	€308	€338	€325	€319	€304
Apparel	162	145	197	99	70
Footwear	73	72	60	50	44
Other hardware*	268	249	274	255	215

*Other hardware includes irons, putters, golf balls, golf bags, gloves and other accessories.
Source: adidas Group annual reports, various years.

exhibit also presents the TaylorMade-adidas Golf division's sales by product category for 2004–2008. Its apparel segment included adidas Golf and Ashworth branded shirts, pants, and outerwear. The company outsourced 92 percent of its production of golf clubs and 96 percent of accessories such as golf balls and golf bags from suppliers in Asia to improve its operating margins. As of 2009, TaylorMade-adidas Golf did not offer consumers the option of purchasing clubs or apparel while visiting its Web site.

Titleist/CobraG olf

Titleist golf balls were developed in 1932 after the founder of an Acushnet, Massachusetts, rubber deresinating company concluded that a bad putt during his round of golf was a result of a faulty ball rather than poor putting. Philip Young took the ball to a dentist's office to have it X-rayed and found that the core of the ball was indeed off-center. Young believed that the Acushnet Processing Company could develop and manufacture high quality golf balls and teamed with a fellow MIT graduate, Fred Bommer, to create the Titleist line of balls. Young and Bommer introduced their first Titleist golf ball in 1935 and by 1949 Titleist had become the most played ball on the PGA Tour.

Acushnet's acquisition of John Reuter, Jr., Inc. in 1958 and Golfcraft, Inc., in 1969 put Titleist into the golf club business. Titleist's Reuter Bulls Eye putter became a favorite on the PGA Tour during the 1960s and its AC-108 heel-toe weighted irons were among the most popular brands of irons during the early-1970s. The company's Pinnacle line of golf balls was developed in 1980 as a lower priced alternative to Titleist branded golf balls. In 1996, The Acushnet Company was acquired by tobacco and spirits producer and marketer American Brands. American Brands increased its presence in the golf equipment industry in 1985 when it acquired Foot-Joy, the number-one seller of golf gloves and shoes. In 1996 American Brands acquired Cobra Golf for $715 million. The company changed its name to Fortune Brands in 1997 when it completed its divestiture of tobacco businesses that began in 1994.

In 2008, Fortune Brands' golf division had become the world's largest seller of golf equipment with sales of $1.4 billion. Titleist was the number-one brand of golf balls with a 40 percent market share and annual sales approximating $650 million in 2008. Fortune Brands' FootJoy brand led the industry in the sale of golf shoes, golf gloves, and golf outerwear with a 60 percent market share and 2008 revenues of about $300 million. The remainder of the golf division's 2008 revenues were nearly equally divided between Cobra and Titleist branded golf clubs and accessories at about $200 million each.

Titleist golf balls were considered to be technologically superior to other brands by most golfers, although Callaway Golf's Tour-i and Nike One golf balls were considered equally impressive by industry analysts and golf retailers. Titleist's Pro V1 golf ball was the company's most advanced and expensive golf ball and was able to offer maximum distance along with spin rates that allowed low-handicap golfers to stop approach shots near the pin. Pro V1 was the number-one selling golf ball in the industry and accounted for about 22 percent of industry sales. A one dozen–sized box of Titleist Pro V1 golf balls carried a suggested retail price of $58. The remainder of Titleist's 40 percent market share in golf balls was made up of its lesser priced NXT and DT models and its value-priced Pinnacle sub-brand.

The company had remained the largest seller of golf balls since 1949 through a heavy reliance on endorsements by touring professionals and a long-running advertising campaign boasting Titleist's status as the "most played ball on the Tour."[13] More than 100 PGA Tour professionals had endorsement contracts with Titleist to play the Pro V1, which ensured that the Pro V1 would be played by at least 75 percent of the field in any PGA Tour event. Fifty of its tour staff members also endorsed Titleist golf clubs and Foot-Joy shoes and apparel. The company also compensated about 50 golfers on other professional tours to use Titleist golf balls during competitive events and gave free boxes of sample golf balls to top amateurs and club champions. The company also gave 15,000 two-ball packs to club professionals in 2007 to distribute to club members.

Titleist's line of golf clubs was targeted toward professional golfers and elite recreational players. The company's forged iron design was not that different from its AC-108 irons produced in the early 1970s and offered very little or no element of forgiveness for poorly struck shots. Titleist's market share in the iron category was less than 2.5 percent in 2007. The perception among even very good golfers that "I'm not good enough" to use Titleist irons had allowed the brand's market share to slowly erode from about 10 percent in 2002.[14] Fortune Brands' Cobra line of irons was designed to appeal to lesser skilled golfers and included many of the technological features found in Callaway Golf, Ping, and TaylorMade irons. Cobra produced four game improvement lines including two multi-material iron lines, a perimeter-weighted line, and a combination set of perimeter-weighted irons and hybrids. Cobra also produced a forged line for better players, but overall, held a modest 5 percent market share in 2007. Even though Cobra had signed endorsement contracts with rising PGA Tour stars like Camillo Villegas, J. B. Holmes, and Ian Poulter, core recreational golfers remained hesitant to abandon more widely used brands for Cobra's $500–$700 iron sets.

Cobra's chief manager was given control over Titleist's line of irons in 2007 to develop products for golfers who aspired to Titleist branded products, but were realistic about their abilities. Titleist's AP1 and AP2 line of irons that were introduced in 2008 retained the look of a forged iron, but offered some forgiveness for mis-hit shots. The company's Z Muscle forged irons were used by many of Titleists staff golfers playing on professional tours, while its Z Blend line of iron sets included a mix of more-difficult-to-hit forged irons and easier-to-hit perimeter-weighted irons. The new product lines carried retail prices between $700 and $1,000 and had not produced any discernable growth in sales by mid-2009.

Titleist offered one driver model—the 909, which came in a 440cc version and two 460cc versions. Titleist also produced two versions of its 909 fairway wood and a single line of hybrid clubs. Titleist drivers, fairway woods, and hybrids were popular choices with professionals and better recreational golfers. The 909 driver line carried a retail price of $400, while 909 fairway woods and hybrid clubs carried retail prices of $200 and $190, respectively. Fortune Brands' Cobra lines of drivers, fairway woods, and hybrids were targeted to golfers of an average skill level. King Cobra S9-1 driver featured a carbon composite top plate, tungsten weights near the rear of the clubhead, and a titanium clubface and came in five basic models that all met the USGA maximum for size and CT. The King Cobra L5V driver was also a multi-material design that had an adjustable shaft with two face settings to alter the ball flight path and trajectory. King Cobra L5V drivers were sold at retail for $300, while most King Cobra S9-1 drivers sold at $200. The King Cobra S9-1 Pro line of drivers similar to the models used by Cobra's tour professionals carried a retail price of $400. Cobra S9-1 fairway woods retailed for $150–$200, while Cobra Baffler hybrid clubs sold in the $150–$180 price range.

Titleist's Vokey forged wedges were frequently used on the PGA Tour and were favorites of many low-handicap golfers. The Vokey wedge line was named for golf club craftsman Bob Vokey, and held a 22.5 percent share of the wedge category of the golf equipment industry in 2007. Vokey wedges were second in sales only to Cleveland Golf, which held a 24.8 percent market share in the category. Vokey spin milled wedge models accounted for one-half of Titleist's sales of wedges. All Vokey wedges carried a retail price of $110. Vokey spin milled wedges sold in 2009 did not conform to USGA groove dimension specifications that would go into effect in January 2010. The USGA ban on squared grooves had created a spike in demand for wedges in 2008 and 2009 as golfers rushed to purchase the technologically superior products before they were discontinued (see Exhibit 1).

As with its wedge line, Titleist's putter line was named after a famed club designer. The Titleist Scotty Cameron putter line held an approximately 10 percent share of the putter segment and was the most widely purchased premium putter brand. Titleist offered four Scotty Cameron putter models, which were all priced at $300. Cobra's wedges and putters were not widely used on the PGA Tour or among recreational golfers.

Titleist management's biggest concern in 2009 centered on the USGA's interest in lesser performing golf balls. In a special equipment issue of *Inside the USGA* published in October 2005, the editors worried openly that technology might endanger some of golf's most historic courses. The editors recalled how the wound rubber-cored Haskell ball that was developed in 1898 and was popularized during the early 1900s eventually "removed for consideration the Myopia Hunt Club, which hosted four U.S. Opens between 1898 and 1908."[15] The USGA editorial staff continued to speculate that the "confluence of golf science and commercial investment . . . accelerated by the injection of large amounts of capital" might possibly have the same effect on such championship courses as Merion or Oakland Hills.[16] Arguing against the concern, Titleist CEO Wally Uihlein attributed the overall scoring improvement among recreational and tournament golfers to "six contributing factors: (1) the introduction of low-spinning high performance golf balls, (2) the introduction of oversize, thin-faced drivers, (3) improved golf course conditioning and agronomy, (4) player physiology—they're bigger and stronger, (5) improved techniques and instruction, and (6) launch monitors and the customization of equipment."[17] Exhibit 7 presents net sales and operating profit between 2004 and 2008 for Fortune Brands' golf division.

Exhibit 7

Financial Summary for Fortune Brands' Golf Division, 2004–2008 (in millions)

	2008	2007	2006	2005	2004
Net sales	$1,369	$1,400	$1,313	$1,266	$1,212
Operating profit	125	168	166	172	154

Source: Fortune Brands' annual reports, various years.

PingG olf

Perimeter weighting came about due to the poor putting of Karsten Solheim, a General Electric mechanical engineer, who took up golf at the age of 47 in 1954. Solheim designed a putter for himself that he found provided more "feel" when he struck the ball. Solheim moved much of the club head weight to the perimeter of the club face, which created a higher MOI and larger "sweet spot." In addition to perimeter weighting, Karsten Solheim also developed the investment-casting manufacturing process. This process allowed clubheads to be formed from molds, rather than forged from steel—the traditional manufacturing process.

Solheim made his putters by hand from 1959 until 1967 when he left GE and founded Karsten Manufacturing. By the 1970s, Karsten manufactured a full line of perimeter-weighted putters and irons that carried the Ping brand. Solheim named the brand Ping because of the sound the perimeter-weighted clubhead made when it struck the ball. Karsten Manufacturing's Ping line of putters and irons were thought to be among the most technologically advanced throughout the 1980s and reigned as the market leaders. Karsten Manufacturing was renamed Ping, Inc., in 1999.

Karsten Solheim was also the pioneer of custom fitting, with his fitting activities predating the official founding of the company. During the 1960s, touring professionals would meet with Solheim to have him custom-fit putters to their body measurements and, by the 1970s, Solheim had developed a fitting system for irons. His system utilized the golfer's physical measurements, stance and swing, and ball flight to select irons with the optimal lie. The company's irons were sold in 12 color-coded lie configurations to best match recreational golfers' unique fit conditions. Ping invited retailers to 3-day training programs in its Phoenix plant to become better skilled at custom fitting and, in 2009, had provided retailers with 2,000 iron-fitting systems, 1,900 driver-fitting systems, and 2,000 putter-fitting systems.

Ping was an industry leader in the iron segment in 2009—frequently trading the number-one ranking with Callaway Golf. The company offered six lines of irons—the traditional blade S57 irons featured minimal perimeter weighting, the i15 line offered a medium degree of perimeter weighting, and the G15, G10, G5, and Rapture lines had expanded perimeter weighting. Like Callaway Golf FT irons and TaylorMade r7 irons, the Rapture iron line featured a multi-material construction that included a tungsten sole, titanium face, and stainless steel frame. The G15, G10, G5, and Rapture iron lines produced a higher ball flight than other models and was intended for average golfers who were able to produce only modest amounts of clubhead speed. The i15 was designed for better players looking for a moderate ball flight, while the S57 line was suitable for professionals and low-handicap recreational golfers. Ping irons ranged in price from $400 for an 8-club set of G5 irons to $1,225 for an 8-club set of Rapture irons. The company produced a broad line of putters and was a strong runner-up to Odyssey in the putter category of the industry. The majority of Ping's putter line sold in the $90 to $170 range, but its Redwood premium line of putters carried a retail price of $200. The Redwood putter line held a 1.2 percent market share in 2007.

Even though Ping had been known at one time for only its irons and putters, the privately owned company was the fourth largest seller of drivers behind TaylorMade, Callaway Golf, and Titleist/Cobra Golf. The company's 460cc G15 titanium driver was a popular choice for golfers who did not want to tinker with the TaylorMade r7 moveable weight system or did not like the carbon composite design of Callaway Golf's FT drivers. The suggested retail price of the Ping G15 driver was $300. Ping's $400 Rapture V2 driver included the use of tungsten weights to produce a higher launch angle than the G15, but was not a popular seller in 2009. Similarly, its fade-biased i15 driver introduced in fall 2009 had yet to catch on with recreational golfers. Like Callaway Golf, the company had failed to develop a hybrid until 2005 and was struggling to gain market share in the category in 2009. Its $100 G5, $130 G10, $160 G15, $190 i15, and $200 Rapture hybrid lines were most frequently purchased by golfers who had purchased either a Ping driver or Ping irons. Ping fairway woods were also frequently purchased by those owning a Ping driver. Ping G15 fairway woods sold for $200 in retail stores, while Ping i15 fairway woods and Rapture fairway woods typically sold at retail prices of $230 and $250, respectively. The company's wedges were not big sellers in the market. Ping Golf had endorsement contracts with 20 golfers on the PGA Tour and 12 LPGA Tour members, including LPGA Money List leader Lorena Ochoa. Ping Golf did not produce a golf ball in 2009.

NikeG olf

Nike seized upon the instant popularity of Tiger Woods in 1996 by signing the young star to a five year, $40 million contract to endorse Nike shoes and apparel. In 1999 Woods extended the contract for an additional five years for $90 million to endorse Nike's golf ball and golf clubs which would be launched in 2000 and 2002, respectively. Woods extended his contract with Nike a number of times after 1999 for undisclosed amounts, but industry analysts suspected the value of Tiger Woods' endorsement contract with Nike exceeded $25 million per year in 2009.

Nike management's 1996 assessment of Tiger Woods' enduring worldwide popularity was on the mark with PGA tournament viewership doubling when Tiger Woods was in contention for a Sunday win. However, Woods' appeal with television viewers did not always translate into equipment sales. Nike's entry into the golf equipment industry had proven successful in terms of apparel and footwear sales, where it was the second leading seller of golf shoes behind Foot-Joy. Similarly, Nike Golf had achieved notable success in golf balls, with its Nike One, Juice, and Power Distance balls controlling about 10 percent of the market in

2008. However, Nike's sales of golf clubs had never grown to be more than about 2 percent to 3 percent of the market.

Much of Nike Golf's troubles in the marketplace had to do with the image it created when it entered the golf equipment industry in 2002. The company had produced a line of clubs endorsed by Tiger Woods, but any serious golfer watching a televised tournament could tell that the Nike clubs in Tiger's hands bore no resemblance to the poor performing Nike clubs on store shelves. To combat the perception that Nike was not a serious golf equipment manufacturer, the company introduced the improved Sumo and Dymo driver lines between 2006 and 2008 that were produced to the USGA limitations for MOI, volume, CT, and dimensions. The Nike Dymo's STR8-Fit adjustability feature was similar to the adjustability feature used by the TaylorMade r9 and the King Cobra L5V and could produce eight different ball flight paths. As of 2009 the Dymo had yet to catch on with a great number of golfers and the SasQuatch Sumo had proven to be a failure. Many golfers found the bright yellow color used in the SasQuatch Sumo paint scheme distracting. It was also common for golfers to comment that the sound made by the SasQuatch Sumo was too similar to that of an aluminum bat striking a baseball.

Nike Golf also signed 17 PGA Tour members in addition to Tiger Woods to endorse its clubs and golf balls in a further attempt to change opinions among core golfers that it was primarily a marketer of sporting goods and apparel. However, the poor performance of its hybrids, irons, wedges, and putters that were far inferior to those produced by other leading manufacturers may have reinforced the impression held by many golfers that Nike was not a serious golf equipment brand and overshadowed the recent improvement in its drivers. Nike's market share in drivers was estimated at less than 2 percent in 2008.

While Callaway Golf, TaylorMade, Ping, Titleist and Cobra Golf tightly controlled retail prices and allowed markdowns only when a new product line was introduced, Nike Golf equipment almost never sold at the suggested retail price. In 2009, the Nike SasQuatch Sumo 5900 that had a suggested retail price of $300 was sold by most retailers for $150. Its SasQuatch Sumo Square had a suggested retail price of $400, but was usually listed at $200 in retail stores. Nike Dymo adjustable drivers had a suggested retail price of $300, but were typically sold for $200 in most on-course and off-course golf shops. Nike fairway woods carried retail prices of $100 to $150, while its hybrid clubs sold for $90. Nike Ignite, Sasquatch Sumo, and Slingshot irons sets carried list prices of $300 to $700, while its Victory Red line sold for $700 to $900. The name Victory Red was a reference to Tiger Woods' routine of wearing a red shirt on the last day of a tournament. Nike wedge models sold for $50 to $110. Nike putters ranged from $100 to $140. Nike One golf balls sold for $45 per dozen, while its other models carried retail prices between $18 and $22 per dozen.

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Case 4

Competition in the Movie Rental Industry in 2008: Netflix and Blockbuster Battle for Market Leadership

ArthurA. Thompson
TheU niversityo fAl abama

Since 2000, the introduction of new technologies and electronics products had rapidly multiplied consumer opportunities to view movies. It was commonplace in 2008 for movies to be viewed at theaters, on airline flights, in hotels, from the rear seats of motor vehicles equipped with video consoles, in homes, or most anywhere on a laptop or a handheld device like a video iPod. Home viewing was possible on PCs, televisions, and video game consoles. The digital video disc (DVD) player was one of the most successful consumer electronic products of all time; as of 2008, more than 85 percent of U.S. households had DVD players (many had more than one) and increasing numbers of households had combination DVD player/recorders. Sales of combination DVD player/recorders surpassed sales of play-only DVD players in 2007–2008. Many households were attracted to purchasing a digital video recorder (DVR) so that they could easily record TV programs and movies and then replay them at their convenience. Moreover, consumers were increasingly interested in watching movies on their big-screen high-definition TVs and were upgrading to Blu-ray DVD players or player/recorders; both Blu-ray and high-definition technologies enabled more spectacular pictures and a significantly higher caliber in-home movie-viewing experience. Also, making recordings of movies and TV programs and sometimes burning one's own DVDs from downloaded or recorded files were becoming common means of building a personal media-viewing library.

Consumers could obtain movie DVDs through a wide variety of channels. They could purchase them from such retailers as Wal-Mart, Target, Best Buy, Circuit City, and Amazon.com or rent them from a host of local video outlets that frequently included Blockbuster and/or Movie Gallery. They could join Netflix, Blockbuster, or any of several other subscription services and have movie DVDs mailed directly to their own homes. They could subscribe to any of several cable movie channels (such as HBO, Showtime, and Starz), download movies from Apple iTunes and other Web sites, watch movies streamed to their PCs or TVs from a host of Web sites (including those of Netflix and Blockbuster), use their cable or satellite TV remotes to order movies instantly streamed directly to their TVs on a pay-per-view basis, or use the services of several other video-on-demand

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providers (including local phone companies like Verizon and AT&T and Web-based sources such as iTunes, Amazon.com, VOD.com, and Hulu.com). There were even vending machines containing movies for purchase or rental. Some consumers obtained movies illicitly on the Internet via file-sharing programs. New services for Internet delivery of movies, as well as better movie-watching devices, were expected to proliferate over the coming years. The biggest problem downloadable movie sites had in attracting customers was that most people wanted to watch the movies they rented on their biggest TV screen, not their computer monitor. The easiest way to move downloads from a PC to a TV was to burn them onto a DVD, but movie studios so far had been adamantly opposed to using downloaded movie formats that would enable a rented title to play on home DVD players.

Traditionally, movie studios released filmed entertainment content for distribution to companies renting movie DVDs and retailers of movie DVDs three to six months after films were released for showing in theaters. Seven to eight months after theatrical release, movie studios usually released their films to pay-per-view and video-on-demand (VOD) providers. Satellite and cable companies were next in the distribution window, getting access to filmed content one year after theatrical release. Movie studios released films for viewing to basic cable and syndicated networks three years after theatrical release. Recently, however, studios and various movie content aggregators and retailers had experimented with allowing consumers to download certain movies to their computers on the same day that the movie's DVD was released by the studios nationwide for rental or sale in retail stores. In some cases, consumers were permitted to burn the downloaded movie to a blank DVD for playback in a DVD player, allowing them to watch the movies on their TVs or portable devices. It was expected that movie studios would continue to experiment with the timing of the releases to various distribution channels, in an ongoing effort to maximize studio revenues.

Market Size

According to Adams Media Research (AMR), movie DVD sales and rentals amounted to a \$24.9 billion market in the United States in 2007, up from \$22.0 million in 2004.[1] Movie DVD purchases totaled \$15.4 billion, and consumer expenditures for rental movies amounted to \$9.5 billion. Movie rental was the most popular means of obtaining movies for in-home viewing, chiefly because of the much lower cost per movie; an estimated 2.5 billion movies were rented in 2006. The movie rental industry consisted of four segments:

1. In-store rentals (2007 revenues of \$5.8 billion).
2. Rentals via mail (2007 revenues of \$2.0 billion).
3. Video-on-demand (2007 revenues of \$1.3 billion). VOD providers delivered rented movies via (*a*) a file downloaded to a PC (the downloaded movie file could be watched an unlimited number of times during the rental period) or (*b*) streaming the rented movie directly to a TV via a high-speed Internet connection, a cable TV connection, satellite, or a fiber-optic network.
4. Vending machines (2007 revenues of \$400 million).

AMR projected that online subscription spending for rented DVDs would increase 68 percent between 2007 and 2011, rising to \$3.2 billion, or about 37.5 percent of the total video rental market. Exhibit 1 contains details of the estimated sizes of various segments of the media entertainment industry in the United States.

Market Trends in Home Viewing of Movies

The wave of the future in viewing movies at home was widely thought to be in streaming rented movies directly to big-screen high-definition TVs. Household members could order the movies they wanted to rent and

Exhibit 1

Estimated Sizes of Various Market Segments of the Media Entertainment Industry in the United States, 2006–2008 (in millions)

	2008	2007	2006
In-store rentals	$5,826	$6,215	$7,030
Vending machine rentals	388	198	79
By-mail rentals	2,023	1,797	1,291
Total physical film rental market	8,237	8,210	8,400
Cable video-on-demand (VOD)	1,164	1,038	977
Digital VOD	84	28	12
Subscription VOD	35	11	4
Total digital film rental market	1,283	1,077	993
Total film rental market	9,520	9,287	9,393
Physical DVD movie sales at retail	15,419	15,932	16,460
Digital movie sales at retail	170	90	20
Total movie sales at retail	15,589	16,022	16,480
Video game software (rental and retail)	6,047	6,016	4,864
Video game hardware and accessories	5,161	6,353	4,218
Total video game market	11,208	12,369	9,082
Total U.S. media entertainment market	$36,317	$37,678	$34,955

Source: As reported in Blockbuster's 2008 10-K report, p. 5.

instantly watch either online (from Netflix, Blockbuster, or other online subscription services with instant video-streaming capability via the Internet) or by using their TV remotes to place orders from their cable or satellite provider. Providing VOD had been technically possible and available for a number of years, but it had not garnered substantial usage because movie studios were leery of the potential for movie-pirating and doubtful of whether they could profit from a VOD business model. But streaming video was less subject to pirating, and recent advances in video-streaming technology were rapidly improving the prospects that VOD would emerge as the dominant movie rental channel within the next 5–10 years.

In addition, there were a number of other important trends and developments in the movie rental marketplace:[2]

- Sales of movie DVDs had slowed from double-digit to single-digit levels in 2006–2007. Online rentals of movie DVDs, computer downloads of music and movie files, growing consumer interest in video-on-demand (VOD) services, and growing popularity of high-definition TV programs were cited as factors.
- Prices for wide-screen, high-definition TVs had been dropping rapidly, and picture quality was exceptionally good, if not stunning, on increasing numbers of models.
- Starting in 2009, all TV stations in the United States were required by law to use digital technology and equipment to broadcast all their programs, a requirement that would result in far more programs being transmitted in high-definition format.
- The flood of new and old TV shows on DVDs that had recently hit retailers' shelves had cut into the sales of movie DVDs—however, the multidisc sets of many of these TV shows were more expensive than most new releases of movie DVDs.
- Hollywood movie producers were hoping that next-generation, high-definition (HD) optical-disc-format DVDs that incorporated Blu-ray technology would rejuvenate sales of movie DVDs. The Blu-ray format offered more than five times the storage capacity of

traditional DVDs and used advanced video and audio capabilities that provided users with an unprecedented HD experience. But it remained to be seen whether Blu-ray movie DVDs would spur movie DVD sales, given the growing popularity of digital video recorders (DVRs), VOD, and online rentals.

- Cable companies like Comcast were offering VOD options for many of their premium movie channels. The Starz Entertainment Group claimed its research showed that Comcast customers who were using the Starz on Demand VOD service tended to reduce their purchases and rentals of movie DVDs due to the ease of using the VOD service.
- Cable and satellite TV companies were promoting their VOD services and making more movie titles available to their customers.
- Cable and satellite TV customers with DVRs could readily substitute VOD movie offerings from their cable/satellite TV provider for purchasing or renting movie DVDs (although selection was generally morel imited).
- Online rentals and VOD services were not only cutting into sales of movie DVDs but also taking business away from local video rental stores. Just as Netflix posed a competitive threat to customers patronizing local Blockbuster and Movie Gallery stores in the United States, market research in Great Britain indicated that one out of every five DVDs rented was rented online.

Netflix and Its Subscription-based Business Model for Renting Movies

By 2008, having revolutionized the way that many people rented movies, Netflix had become the world's largest online entertainment subscription service. It had attracted 8.4 million subscribers, who paid monthly fees ranging from $4.99 to $47.99; subscribers went to Netflix's Web site, selected one or more movies from its library of 100,000 titles, and received the movie DVDs by first-class mail generally within one business day—more than 95 percent of Netflix's subscribers lived within one-day delivery of the company's 50 distribution centers (plus 50 other shipping points) located throughout the United States. Subscribers could keep a DVD for as long as they wished, with no due dates or late fees, although they were limited to having a certain number of DVDs in their possession at any one time (depending on which fee plan they had chosen). Subscribers returned DVDs via the U.S. Postal Service in a prepaid return envelope that came with each movie order. The company also had a growing library of more than 12,000 full-length movies and television episodes that subscribers could watch instantly on their televisions or PCs for no additional cost. Netflix had been rated number one in online retail customer satisfaction by Nielsen Online and for seven consecutive periods by Foresee/FGI Research.

A unique aspect of Netflix's pioneering business model was that it provided subscribers with all the benefits of a local movie rental store but without the hassle of having to drive to the store, pick out movie DVDs from a selection of primarily recent releases, and return the rentals by a specified time. Netflix's positive and rapidly growing profits over the past five years had convinced skeptics that its wholly online business model for renting DVDs and streaming video was indeed viable, despite the fact that movie rental leader Blockbuster (which at one time had 9,000 company-operated and franchised stores worldwide) had entered the online movie rental segment and tried to horn in on the market opportunity that Netflix was so rapidly exploiting. Walmart had pursued online movie rentals for a short time, but in May 2005 had decided to enter into an arrangement with Netflix whereby Walmart would refer customers interested in online DVD rentals to Netflix, while Netflix would steer customers wanting to purchase a movie DVD to Walmart's Web site. Amazon.com had considered entering the online movie rental market but in the end opted not to take on Netflix. Entry barriers into online DVD rentals were relatively low, but the barriers to profitability were considered rather high because of the need to attract 2 to 4 million subscribers in order to operate profitably.

Nonetheless, Reed Hastings, founder and CEO of Netflix, remained concerned about how to make the company's service offerings even better (identifying additional strategic moves to outcompete Blockbuster) and most particularly how to stay ahead of other competitors that were either already offering movies on a pay-per-view basis to Internet customers with high-speed broadband connections or else were gearing up to do so. Hastings's goals for Netflix were simple: to build the world's best Internet movie service and to deliver a growing subscriber base and earnings per share every year.

CompanyB ackground

After successfully founding his first company, Pure Software, in 1991, Reed Hastings engineered several acquisitions and grew Pure Software into one of the 50 largest software companies in the world—the company's principal product was a debugging tool for engineers. When Pure Software was acquired by Rational Software in 1997 for $750 million, Hastings used the money from selling his shares of Pure Software to help fund his pursuit of another entirely different business venture. Sensing the opportunity for online movie rentals in a climate where the popularity of the Internet was mushrooming, he founded Netflix in 1997, launched the online subscription service in 1999, and attracted a base of more than 2 million subscribers in just four years. (In contrast, America Online took six years to acquire the same number of subscribers.) Netflix quickly discovered that new subscribers were drawn to try its online movie rental service because of the wide selection; the extensive information Netflix provided about each movie in its rental library (including critic reviews, member reviews, online trailers, ratings); the ease with which they could find and order movies; the elimination of late fees and due dates; and the convenience of being provided a postage-paid return envelope for mailing the DVDs back to Netflix.

The company's extensive marketing campaigns from 2001 into 2008 had produced widespread consumer awareness of the Netflix name, its distinctive red logo, and its movie rental service. By July 2008, Netflix had 8.4 million subscribers. Exhibit 2 shows trends in Netflix's subscriber growth.

Netflix had 2007 revenues of $1.2 billion (up from $501 million in 2004), and its 100,000 movie titles (up from 55,000 in 2005) far outdistanced the selection available in local brick-and-mortar movie rental stores. Netflix's DVD lineup included everything from the latest big Hollywood releases to hard-to-locate documentaries to independent films to TV shows and how-to videos. Subscriber growth had been fueled by the rapid adoption of DVDs as a medium for home entertainment as well as by increased awareness of online DVD rentals.

Netflix'sS trategy

Netflix's success in building a bigger subscriber base was due to its six-pronged strategy of providing comprehensive selection of movie DVDs, an easy way to choose movies, fast delivery of selections, no due dates for return, and a convenient drop-it-in-the-mail return procedure, coupled with aggressive marketing to attract subscribers and build widespread awareness of the Netflix brand and service. The sought-for competitive advantage over other movie rental competitors was to deliver compelling customer value and customer satisfaction by eliminating the hassle involved in choosing, renting, and returning movies.

Going forward, Netflix had two primary strategic objectives: (1) to continue to grow a large DVD subscription business and (2) to expand rapidly into Internet-based delivery of content as that market segment developed. Management's long-term growth strategy for Netflix was predicated on two beliefs: (1) that the DVD format, along with high-definition successor formats such as Blu-ray, would be

Exhibit 2

Subscriber Data for Netflix, 2000–2007 (in thousands, except subscriber acquisition cost)

	2000	2001	2002	2003	2004	2005	2006	2007
Total subscribers beginning of period	107	292	456	857	1,487	2,610	4,179	6,316
Gross subscriber additions during period	515	566	1,140	1,571	2,716	3,729	5,250	5,340
Subscriber cancellations during the period	330	402	739	941	1,593	2,160	3,113	4,177
Total subscribers at end of period	292	456	857	1,487	2,610	4,179	6,316	7,479
Net subscriber additions during the period	185	164	401	630	1,123	1,569	2,137	1,163
Free trial subscribers*	n.a.	n.a.	56	61	71	153	162	153
Subscriber acquisition cost	$110.79	$49.96	$37.16	$32.80	$37.02	$38.77	$42.96	$40.88

n.a. = Not available.

*First-time subscribers automatically were eligible for a free two-week trial; membership fees began after the two-week trial expired (unless the membership was canceled).

the main vehicle for watching content in the home for the foreseeable future and (2) that by growing a large DVD subscription business based on mail delivery, Netflix would be well positioned to transition its subscribers to Internet-based delivery of content. In January 2007, Netflix introduced an instant-watching feature for PCs that allowed subscribers to view selections from Netflix's library of 12,000 full-length movies and television episodes streamed over the Internet directly to their PC monitors. Shortly thereafter, the company began efforts to broaden the distribution of instant-watching capability to other platforms and partners over time. In 2008, LG Electronics introduced a set-top box device that enabled Netflix's instant-watching selections of movies and TV episodes to be viewed directly on subscribers' television screens. Netflix anticipated that other consumer electronics manufacturers would soon introduce similar devices, thus paving the way for more subscribers to begin the expected switchover from postal delivery to Internet-based delivery.

In October 2008, Netflix and Starz Entertainment, a premium movie service provider operating in the United States, announced an agreement to make movies from Starz, through its Starz Play broadband subscription movie service, available to be streamed instantly at Netflix. Access to the Starz Play service at Netflix was included with Netflix members' current monthly subscription fee. The agreement with Starz Play gave Netflix members access to an additional 2,500 movies that could be streamed directly to their TVs and boosted Netflix's library of instantly watchable movies from 12,000 to 14,500.

Management expected that at some point Internet delivery of media content would surpass postal delivery and that eventually postal delivery would account for a relatively small fraction of Netflix's business. Internet delivery of media content was segmented into the rental of Internet-delivered content, the download-to-own segment, and the advertising-supported online delivery segment. Netflix's objective was to be the clear leader in the rental segment via its instant-watching feature.

A WIDE CHOICE OF SUBSCRIPTION PLANS In 2008, Netflix members had the choice of eight "unlimited" subscription plans:

- $8.99 Unlimited DVDs each month, one title out at a time, plus unlimited streaming.
- $13.99 Unlimited DVDs each month, two titles out at a time, plus unlimited streaming.
- $16.99 Unlimited DVDs each month, three titles out at a time, plus unlimited streaming.
- $23.99 Unlimited DVDs each month, four titles out at a time, plus unlimited streaming.
- $29.99 Unlimited DVDs each month, five titles out at a time, plus unlimited streaming.
- $35.99 Unlimited DVDs each month, six titles out at a time, plus unlimited streaming.
- $41.99 Unlimited DVDs each month, seven titles out at a time, plus unlimited streaming.
- $47.99 Unlimited DVDs each month, eight titles out at a time, plus unlimited streaming.

The company also offered one "limited" plan for $4.99, which entailed a maximum of two DVDs per month with two hours of video streaming to a PC. This plan did not allow members to stream movies to their TV via a Netflix-ready device—as was the case with the eight unlimited plans.

The most popular subscription plan was the $16.99 plan (three DVDs at a time, with unlimited streaming). Subscribers could cancel anytime. New subscribers were automatically eligible for a free two-week trial that provided full access to the whole library of 100,000 movie titles and unlimited streaming to PCs.

Management believed that Netflix's subscriber base consisted of three types of customers: those who liked the convenience of home delivery, bargain hunters who were enthused about being able to watch 10 or more movies a month at an economical price (on the $16.99 plan, 12 movies equated to a rental fee of $1.42 per movie), and movie buffs who wanted access to a very wide selection of films.

NETFLIX'S PROPRIETARY MOVIE RECOMMENDATION SOFTWARE Netflix had developed proprietary software that enabled it to provide subscribers with detailed information about each title in the Netflix library as well as personalized movie recommendations every time they visited the Netflix Web site. The information provided for each title included length, rating, cast and crew, screen formats, movie trailers, plot synopses, and reviews written by Netflix editors, third parties, and subscribers. The personalized recommendations were based on a subscriber's individual likes and dislikes (determined by their rental history, their personal ratings of movies viewed, movies in the subscriber's queue for future delivery, and titles posted to a wish list), movie ratings, and the average rating by all subscribers. Subscribers often began their search for movie titles by starting from a familiar title and then using the recommendations tool to find other titles they might enjoy.

The recommendation software was designed around an Oracle database and proprietary algorithms that organized Netflix's library of movies into clusters of similar movies and analyzed how customers rated them after they rented them. Those customers who rated similar movies in similar clusters were then matched as like-minded viewers. When a customer was online, the software was programmed to check the clusters the subscriber had rented from in the past, determine which movies the customer had yet to rent in that cluster, and recommend only those movies in the cluster that had been highly rated by viewers. Viewer ratings determined which available titles were displayed to a subscriber and in what order. The recommendations helped subscribers quickly create a list, or queue, of movies they wanted to see. Subscribers used this queue to specify the order in which movies would be delivered; they could alter their queue at any time. Netflix management saw the movie recommendation tool as a powerful means of enticing customers to spend time browsing through its expansive content library and locating movies they would like to see.

In 2008, Netflix had more than 2 billion movie ratings from customers in its database, and the average subscriber had rated more than 200 movies. These ratings were used to determine which titles to feature most prominently on the company's Web site, to generate lists of similar titles, and to select the promotional trailers that a subscriber would see when using the Previews feature. Netflix management believed that more than 50 percent of its rentals came from the recommendations generated by its recommendation software. The software algorithms were thought to be particularly effective in promoting selections of smaller, high-quality films to subscribers who otherwise might have missed spotting them in the company's massive 100,000-film library (to which new titles were continuously being added). On average, more than 85 percent of the movie titles in the Netflix library of offerings were rented each quarter, an indication of the effectiveness of the company's recommendation software in steering subscribers to movies of interest and achieving broader utilization of the company's entire library of titles.

QUICK DELIVERY CAPABILITY Netflix had 50 regional shipping centers and another 50 shipping points scattered across the United States, giving it one-business-day delivery capability for 95 percent of its subscribers. In 2008, Netflix was shipping more than 2 million DVDs a day (outside of holidays and weekends) from its inventory of around 70 million DVDs, which was growing as the subscriber base increased.

Netflix had developed sophisticated software to track its inventory and minimize delivery times. Netflix's system allowed the distribution centers to communicate to determine the fastest way of getting the DVDs to the customers. When a customer placed an order for a specific DVD, the system first looked for that DVD at the shipping center closest to the customer. If that center didn't have the DVD in stock, the system then moved to the next closest center and checked there. The search continued until the DVD was found, at which point the shipping center was provided with the information needed to initiate the order fulfillment and shipping process. If the DVD was unavailable anywhere in the system, it was waitlisted. The system then moved to the customer's next choice, and the process started all over. And no matter where the DVD was sent from, the system knew to print the return label on the prepaid envelope to send the DVDs to the shipping center closest to the customer to reduce return times and permit more efficient use of the company's DVD inventory.

NEW CONTENT ACQUISITION In the first six months of 2008, Netflix spent $120.3 million on the acquisition of new movie DVDs and movie/TV content for online streaming; new content was acquired from movie studios and distributors through direct purchases (usually on a fee-per-DVD basis), revenue-sharing agreements, and licensing. Netflix acquired many of its new-release movie DVDs from studios for a low up-front fee plus a percentage of revenue earned from rentals for a defined period. After a revenue-sharing period expired for a title, Netflix generally had the option of returning the title to the studio, purchasing the title, or destroying its copies of the title. In the case of movie titles and TV episodes that were delivered to subscribers via the Internet for instant viewing, Netflix generally paid a fee to license the content for a defined period of time; in most instances, these license agreements could be extended or renewed.

The company's June 30, 2008, balance sheet indicated that its content had a net value of $126.9 million (after depreciation). New-release DVDs were amortized over one year; the useful life of back-library titles (some of which qualified as classics) were amortized over three years (since the personalized movie recommendations generated significant rentals of older titles). DVDs that the company expected to sell at the end of their useful lives carried a salvage value of $3 per DVD; DVDs that the company did not expect to sell were assigned a salvage value of zero.

MARKETING AND ADVERTISING Netflix used multiple marketing channels to attract subscribers, including online advertising (paid search listings, banner ads, text on popular sites such as AOL and Yahoo!, and permission-based e-mails), radio stations, regional and national television, direct mail, and print ads. It also participated in a variety of cooperative advertising programs with studios through which Netflix received cash consideration in return for featuring a studio's movies in its advertising.

Advertising campaigns of one type or another were under way more or less continuously, with the lure of two-week free trials usually being a prominent feature of most ads. Management had boosted marketing expenditures from $25.7 million in 2002 (16.8 percent of revenues) to $98 million in 2004 (19.6 percent of revenues) to $142.0 million in 2005 (20.8 percent of revenues) to $223.4 million in 2006 (22.4 percent of revenues) before cutting back slightly to $216.1 million in 2007 (17.9 percent of revenues) and then $95 million in the first six months of 2008 (14.3 percent of revenues). Netflix management believed that its paid advertising efforts were significantly enhanced by the benefits of word-of-mouth advertising, the referrals of satisfied subscribers, and its active publicr elationsp rograms.

Netflix's Performance and Prospects

Recent financial statement data for Netflix are shown in Exhibits 3 and 4. Management's latest forecast called for having between 9.1 and 9.7 million subscribers by year-end 2008, full-year revenues of about $1.37 billion, net income in the range of $75–$83 million, and diluted earnings per share of $1.19 to $1.31. In January 2008, the company announced that it would spend $100 million to repurchase shares of its common stock; the buyback resulted in the repurchase of 3.8 million shares at an average price of $25.96. In March 2008, Netflix's board of directors authorized a second repurchase program whereby the company would spend an additional $150 million to buy back shares during the remainder of 2008. In September 2008, Netflix's stock was trading in $30–$33 range.

Blockbuster: The World Leader in Movie Rentals

Blockbuster was the global leader in the movie rental industry. In 2008, it had an estimated 40 percent share of the roughly $9.5 billion U.S. market for renting movies for in-home viewing and a globally recognized brand in movie rentals. Founded in Dallas, Texas, in 1985, Blockbuster had pursued an aggressive growth strategy, reaching a peak of 9,094 company-operated and franchised movie rental stores worldwide by year-end 2004, with 7,265 company-operated stores (including 2,557 outside the United States) and 1,829 franchised Blockbuster stores (some 734 of which were outside the United States). Blockbuster's 3,291 international store locations at year-end 2004 were scattered across 24 countries, but 87 percent were in the following countries: Great Britain (897), Canada (426), Australia (408), Mexico (317), Italy (241), Ireland (199), Brazil (131), Taiwan (128), and Spain (106).

However, during 2005–2007, amid adverse market and competitive conditions and hemorrhaging losses, Blockbuster closed more than 700 of its company-operated stores in the United States and nearly 500 of its company-operated stores outside the United States. The total number of franchised stores had fallen modestly from 1,829 to 1,757 as of year-end 2007. An additional 137 company-owned stores and 96 franchised stores were closed or sold worldwide in the first six months of 2008. As of July 2008, Blockbuster had a total of 7,619 stores in the United States and 20 other countries, including 3,939 company-operated stores in the United States, 2,013 company-owned stores outside the United States, and 1,630 franchised stores domestically and internationally.

Blockbuster recorded net losses of $2.8 billion during the 2003–2005 period, earned a modest $39.2 million after-tax profit in 2006, and lost $85.1 million in 2007—see Exhibit 5 on page 313. The company had announced that it expected to report full-year 2008 net income in the range of $21 to $36 million, despite reporting a net loss of $2.1 million for the first six

Exhibit 3

Netflix's Consolidated Statements of Operations, 2000–2007 (in millions, except per share data)

	2000	2002	2004	2005	2006	2007
Revenues	$ 35.9	$152.8	$500.6	$682.2	$996.7	$1,205.3
Cost of Revenues:						
Subscription costs	24.9	78.1*	273.4	393.7	532.6	664.4
Fulfillment expenses	10.2	19.4	56.6	70.8	93.4	121.3
Total cost of revenues	35.1	97.5	330.0	464.6	626.0	785.7
Gross profit	0.8	55.3	170.6	217.7	370.7	419.6
Operating expenses						
Technology and development	16.8	14.6	22.9	30.9	44.8	67.7
Marketing	25.7	35.8	98.0	142.0	223.4	216.1
General and administrative	7.0	6.7	16.3	29.4	30.1	46.8
Stock-based compensation	9.7	8.8	16.6	14.3	12.7	12.0
Gain (loss) on disposal of DVDs	—	—	(2.6)	(2.0)	(4.8)	(7.2)
Gain on legal settlement	—	—	—	—	—	(7.0)
Total operating expenses	59.2	65.9	151.2	214.7	306.2	328.4
Operating income	(58.4)	(10.7)	19.4	3.0	64.4	91.2
Interest and other income (expense)	(0.2)	(10.3)	2.4	5.3	15.9	20.3
Income before income taxes	—	(20.9)	21.8	8.3	80.3	111.5
Provision for (benefit from) income taxes	—	—	0.2	(33.7)	31.2	44.5
Net income	$ (58.5)	$ (20.9)	$ 21.6	$ 42.0	$ 49.1	$ 67.0
Net income per share:						
Basic	$ (20.61)	$ (0.74)	$ 0.42	$ 0.79	$ 0.78	$ 1.00
Diluted	(20.61)	(0.74)	0.33	0.64	0.71	0.97
Weighted average common shares outstanding:						
Basic	2.8	28.2	52.0	53.5	62.6	67.1
Diluted	2.8	28.2	64.7	65.5	69.1	68.9

*Includes sales costs of $1.1 million.
Note: Totals may not add due to rounding.
Source: Company 10-K reports for 2003, 2005, and 2007.

months of 2008. To improve the company's 2008 financial performance and avoid another year of losses, senior management had launched efforts to cut general and administrative expenses at the corporate level by $100 million, and during the first half of 2008 alone, advertising expenses had been trimmed by $65 million (about 60 percent).

Blockbuster's financial troubles stemmed in part from its split-off from media conglomerate Viacom in October 2004 (Viacom had acquired Blockbuster in 1994 for $8.4 billion); part of the split-off arrangement involved paying a special one-time $5 dividend (totaling $905 million) to all shareholders, including Viacom (which owned 81.5 percent of Blockbuster's shares prior to the divestiture deal). A cash payment of this size proved to be a considerable financial burden, thrusting Blockbuster into a weak financial condition and limiting the financial resources available for overcoming sluggish sales at its stores and eroding movie rentals. The company's revenues in 2007 were $500 million below the 2004 level. Since becoming an independent company in 2004 (when it split off from Viacom), Blockbuster had seen its stock price trend steadily downward, falling from a high of $10 in 2004 to $1.90 per share as of October 2, 2008. In July 2007, James F. Keyes, former president and CEO of 7-Eleven, was

Exhibit 4

Selected Balance Sheet and Cash Flow Data for Netflix, 2000–2007 (in millions)

	2000	2002	2004	2005	2006	2007
Selected Balance Sheet Data						
Cash and cash equivalents	$14.9	$ 59.8	$174.5	$212.3	$400.4	$177.4
Short-term investments	—	43.8	—	—	—	207.7
Current assets	n.a.	107.1	187.3	243.7	428.4	416.5
Net investment in DVD library	n.a.	10.0	42.2	42.2	104.9	132.5
Total assets	52.5	130.5	251.8	251.8	608.8	647.0
Current liabilities	n.a.	40.4	94.9	94.9	193.4	212.6
Working capital*	(1.7)	66.6	92.4	148.8	235.0	203.9
Notes payable, less current portion	1.8	—	—	—	—	—
Stockholders' equity	(73.3)	89.4	156.3	226.3	430.7	414.2
Cash Flow Data						
Net cash provided by operating activities	$(22.7)	$ 40.1	$147.6	$157.5	$247.9	$291.8
Net cash used in investing activities	(25.0)	(67.3)	(68.4)	(133.2)	(185.9)	(450.8)
Net cash provided by financing activities	48.4	70.9	5.6	13.3	126.2	(64.0)

*Defined as current assets minus current liabilities.
Sources: Company 10-K reports for 2003, 2005, and 2007.

appointed to replace John F. Antioco, who had served as Blockbuster's CEO since 1997. Keyes quickly initiated a series of efforts to recast Blockbuster's strategy and put the company in better position to improve its dismal bottom-linep erformance.

Blockbuster'sS trategy,2 002–2006

In 2002, Blockbuster announced a strategic vision of becoming the complete source for movies and video games—rental and retail. Already the leader in the movie and game rental market, the company set its sights on increasing sales and market share by launching a variety of promotional campaigns and expanding its in-store selection of movies and gaming equipment, including hardware, software, and accessories.

NEW VIDEO GAME STRATEGIC INITIATIVES To expand its presence in the gaming marketplace, in 2002 Blockbuster purchased the United Kingdom–based video game retailer Gamestation and proceeded to expand the chain from 64 to more than 150 stores. Meanwhile, Blockbuster started a Game Freedom Pass rental subscription program in all of its U.S. company-operated stores. Customers could purchase a single-month pass for just $19.99 and get unlimited video game rentals for 30 consecutive days with a maximum of one game rented at any given time, and no extended viewing fees during the 30 days; a gamer could keep one game for the entire 30 consecutive days or change out the game daily—or even multiple times a day.

Several other initiatives in video games were launched in 2004–2005. Blockbuster began carrying PlayStation Portable handheld games for rent in all stores. And it had boosted its games offering by creating a special section called Game Rush within certain high-traffic Blockbuster stores; Game Rush customers could rent, sell, or buy new and used game software and hardware. During peak hours, Game Rush sections were staffed by specially trained game specialists. Blockbuster believed that about half of its U.S. stores were suited to having a special Game Rush section.

IN-STORE MOVIE RENTAL SUBSCRIPTION PROGRAMS In 2003, Blockbuster initiated an in-store movie rental subscription program in approximately 25 percent of its stores. The program was rolled out to all U.S. company-operated stores in 2004 under the banner Blockbuster Movie Pass. For $24.99 per month, members could take up to two movies out at a time; for $29.99 per month, they could have three movies out on rental at a time. Both plans entitled customers to watch all the movies they wanted, with no specified return dates and no extended viewing fees. Once customers joined the Movie Pass program, their credit card or debit card was automatically charged the monthly fee; subscriptions could be canceled at any time.

EXPANSION INTO ONLINE RENTALS

In August 2004, Blockbuster launched an online subscription service in the United States and a smaller online service in Great Britain (where it also had almost 900 Blockbuster stores). In the United States, customers were offered a choice of three monthly plans (all with unlimited rentals and no due dates or late fees): (1) a $19.99 plan with three DVDs out at a time, (2) a $29.99 plan with five DVDs out at a time, and (3) a $39.99 plan with eight DVDs out at a time. At the time, customers could choose from 25,000 titles, ranging from classics to new releases. In addition, subscribers were e-mailed two e-coupons each month for free in-store rentals; all Blockbuster Online members were eligible for exclusive deals and discounts at participating Blockbuster stores. Rentals were shipped from 11 distribution centers to subscribers via first-class mail and usually arrived in one to three business days. Subscribers were provided with a postage-paid envelope for returning the DVDs. Subscribers could create and maintain a personal queue of movies they wished to rent at Blockbuster's Web site. When Blockbuster received return DVDs from subscribers, it automatically shipped the next available titles in the subscriber's rental queue.

Management said entry into online rentals represented an ongoing effort to transform Blockbuster from a chain of neighborhood movie rental stores into an "anywhere, anytime" entertainment destination that eventually would enable customers to rent, buy, or trade both new and used movies and games, in-store and online. The initial response was promising; according to Blockbuster's CEO, John Antioco, "After six weeks, we had more subscribers than Netflix had in a year and a half of existence."

On December 22, 2004, Blockbuster cut the price on its most popular online subscription plan (unlimited rentals, three titles out at a time) from $19.99 per month to $14.99 and announced it was expanding the copy-depth of new-release movies, boosting the number of titles available for online rental to 30,000, and adding more variety to its library of both TV shows and movies. It also announced that it was increasing the number of shipping centers to 23 and implementing new technology with the U.S. Postal Service that would shorten delivery times.

In August 2005, Blockbuster Online's pricing was raised. Customers could choose from among three plans:

- $9.99, one title out at a time, no monthly rentall imits.
- $14.99, two titles out at a time, no monthly rentall imits.
- $17.99, three titles out at a time, no monthly rental limits.

The $17.99 plan was the most popular. All new subscribers received a free two-week trial. The company had 1 million online subscribers and, during 2005, reportedly added about as many net new subscribers as Netflix. Also in 2005, Blockbuster integrated its in-store and online subscription program—members paid the same fees and had the same privileges.

As of mid-2005, online subscribers could choose from over 40,000 titles. Blockbuster had 30 distribution centers, and more than 200 local Blockbuster stores were fulfilling online orders for nearby customers (to help shorten delivery times). More local stores were being added daily to fulfill online orders. By year-end 2006, Blockbuster had 65,000 titles in its online rental library; its 35 distribution centers and 90 points for mail entry enabled it to deliver orders to 90 percent of online subscribers within one businessd ay.

BLOCKBUSTER'S 2005 DECISION TO DISCONTINUE LATE FEES FOR IN-STORE RENTALS To revitalize stagnant store sales and combat the attractiveness of the no due dates/no late fees policies of Netflix, in January 2005 Blockbuster discontinued its practice of charging late fees on DVD rental returns at its retail stores. However, it held on to the practice of specified due dates—one week for games and two days or one week for movies. If customers kept the rental beyond the due date, they were automatically granted an extra one-week goodwill period at no additional charge. If customers chose to keep their rentals past the end of the seventh day after the due date per the posted rental terms, Blockbuster converted the rental to a sale and charged customers for the movie or game, minus the original rental fee. If customers later decided they did not want to own the movie or game and returned the product within 30 days, Blockbuster reversed the sale and charged a minimal restocking fee of $1.25 (some franchised Blockbuster stores charged a higher restocking fee).

Blockbuster ran extensive ads in December 2004/January 2005 touting its new no-late-fee policy. To help compensate for the estimated $250 to $300 million that late fees were expected to contribute to Blockbuster's revenues in 2005, Blockbuster management reduced 2005 capital spending by more than $100 million, took actions to cut corporate overhead by $70 million on an annualized basis, and put planned strategic initiatives in video games and movie trading on hold until 2006. John Antioco, CEO of Blockbuster at the time, saw the new end-of-late-fees program as the company's best option for addressing one of the biggest complaints that customers had with their in-store rental experience at Blockbuster. Nonetheless, Antioco was under fire from shareholders and some members of the company's board of directors for instituting the no-late-fee policy, given the big revenue erosion impact, Blockbuster's string of huge losses, and the need to increase store inventories of DVDs to compensate for the extra time that customers were keeping the DVDs. Investors and board members were also skeptical about Blockbuster's entry into the online rental market segment because of the heavy costs (estimated at $100 to $200 million) and what some considered as dim prospects for profitability. Later in 2005, about 160 Blockbuster franchisees decided to reinstate late fees because of the loss in revenues and the extra expenses involved in stocking additional copies of popular titles.

Blockbuster'sS trategy Overhaul, 2007–2008

To fulfill its mission of "providing convenient access to media entertainment," in 2008 Blockbuster was moving beyond just renting movies to pursue what management saw as bigger growth opportunities in the broader entertainment market. The company was focusing on three strategic priorities:

- Growing its core movie rental business.
- Broadening the product offerings at local Blockbuster stores.
- Developing new channels for delivery of digital content.

GROWING MOVIE RENTAL REVENUES

One of new CEO Jim Keyes's first actions had been to significantly improve the in-stock availability of hot new releases at Blockbuster stores. Customers going to a local Blockbuster to rent a popular movie or placing an order online for by-mail delivery were often frustrated upon learning that all copies of the movie were out on rental. To attack the out-of-stock problems, Blockbuster boosted its purchases of new movie DVDs for inventory by about 20 percent and improved its inventory management procedures—moves that boosted in-stock availability from 20 percent in June 2007 to nearly 60 percent in May 2008. All stores had signage alerting customers to Blockbuster's new practice of stocking more copies of hit titles. These actions helped reverse the declines in movie rental revenues and same-store sales that had plagued the company since January 2003 (see Exhibit5).

Exhibit 5

Selected Financial and Operating Statistics for Blockbuster Inc., 2002–2007 (in millions, except for per share data)

	2007	2006	2005	2004	2003	2002
Selected Statement of Operations Data						
Revenues						
Rentals	$4,082.5	$4,029.1	$4,160.7	$4,428.6	$4,533.5	$ 4,460.4
Merchandise sales	1,400.1	1,431.9	1,488.9	1,532.6	1,281.6	1,019.7
Other	59.8	61.2	72.2	92.0	96.6	85.8
Total	5,542.4	5,522.2	5,721.8	6,053.2	5,911.7	5,565.9
Cost of rental revenues	1,604.0	1,403.9	1,396.6	1,250.7	1,362.1	1,513.8
Gross margin on rentals	60.7%	65.2%	66.4%	71.8%	70.0%	66.1%
Cost of merchandise sold	1,073.8	1,075.8	1,164.4	1,190.7	1,027.7	844.9
Gross margin on merchandise sales	23.3%	24.9%	21.8%	22.3%	19.8%	17.1%
Gross profit	2,864.6	3,042.5	3,160.8	3,611.8	3,521.9	3,207.2
Gross profit margin	51.7%	55.1%	55.2%	59.7%	59.6%	57.6%
Operating expenses						
General and administrative	2,525.1	2,598.6	2,724.8	2,835.2	2,605.9	2,369.5
Share-based compensation	—	—	—	18.3	—	—
Advertising	194.0	154.3	252.7	257.4	181.8	250.9
Depreciation and intangible amortization	185.7	210.9	224.3	249.7	266.0	239.1
Impairment of goodwill and other long-lived assets	2.2	5.1	341.9	1,504.4	1,304.9	—
Gain on sale of Gamestation	(81.5)	—	—	—	—	—
Total operating expenses	2,825.5	2,968.9	3,543.7	4,865.0	4,358.6	2,859.5
Operating income (loss)	39.1	73.6	(382.9)	(1,253.2)	(836.7)	347.7
Interest expense	(88.7)	(101.6)	(98.7)	(38.1)	(33.1)	(49.5)
Interest income	6.5	9.9	4.1	3.6	3.1	4.1
Other items, net	(1.5)	5.4	(4.2)	—	—	—
Income (loss) before income taxes	(44.6)	(12.7)	(481.7)	(1,286.1)	(867.1)	305.2
Net profit (loss)	$ (85.1)	$ 39.2	$ (583.9)	$(1,248.8)	$ (978.7)	$ 195.9
Earnings per share (diluted)	$ (0.45)	$ 0.21	$ (3.18)	$ (6.89)	$ (5.41)	$ 1.08
Dividends per share	—	—	$ 0.04	$ 5.08	$ 0.08	$ 0.08
Selected Balance Sheet Data						
Cash and cash equivalents	$ 184.6	$ 394.9	$ 276.2	$ 330.3	$ 233.4	$ 152.5
Merchandise inventories	343.9	343.9	310.3	516.6	415.1	452.1
Current assets	1,319.2	1,562.4	1,423.8	1,217.7	960.3	958.9
Total assets	2,733.6	3,134.6	3,179.6	3,863.4	4,822.0	6,243.8
Current liabilities	1,288.5	1,405.4	1,317.9	1,449.4	1,323.4	1,477.6
Long-term debt, less current portion	665.6	851.0	1,059.4	1,044.9	0.7	328.9
Stockholders' equity	655.7	723.3	631.6	1,062.9	3,188.4	4,100.9
Selected Cash Flow Data						
Net cash flow provided by (used for) operations	$ (56.2)	$ 329.4	$ (70.5)	$1,215.4	$1,430.3	$ 1,462.3
Net cash flow provided by (used for) investing activities	76.7	(41.0)	(114.2)	(1,112.3)	(1,024.6)	(1,314.6)
Net cash flow provided by (used for) financing activities	(241.0)	(183.2)	138.3	(18.8)	(335.5)	(199.2)
Worldwide Store Data						
Same-store revenue increase (decrease)	3.4%	(2.1)%	(4.8)%	(3.2)%	(2.2)%	5.1%
Company-owned stores, end-of-year	6,073	6,551	7,158	7,265	7,105	6,907
Franchised stores, end-of-year	1,757	1,809	1,884	1,829	1,762	1,638
Total stores, end-of-year	7,830	8,360	9,042	9,094	8,867	8,545

Source: Blockbuster's 2003 10-K report, 2006 10-K report, and 2007 10-K report.

Other moves to profitably grow revenues from movie rentals at Blockbuster included the following:

- Expanding the selection of independent films—Blockbuster signed an agreement with IFC, a leading provider of independent films, whereby Blockbuster would have exclusive rights to rent IFC titles for a limited period. As of fall 2008, customers could choose from a library of 85,000 titles.
- Refurbishing stores with brighter paint, lower shelves, and new merchandising displays. Some stores had a Rock the Block café area with seating, snacks, and beverages.
- Placing Blockbuster-branded DVD vending machines and high-speed downloading kiosks at high-traffic retail locations to give Blockbuster more points at which it could access customers interested in renting a movie. In August 2008, Blockbuster and NCR Corporation announced a strategic alliance to deploy Blockbuster-branded state-of-the-art DVD vending kiosks for renting movie DVDs; if the initial pilot program for 50 machines proved successful, plans called for a national rollout of as many as 10,000 vending kiosks where consumers could either rent or purchase movie DVDs and video games. Earlier in 2008, Blockbuster and NCR had partnered to test digital movie downloading kiosks in select Blockbusters tores.
- Creating a program called Total Access, through which customers could choose from among any of 11 subscription plans, ranging from as little as $3.99 (one DVD out at a time, limit of two per month) to as much as $34.99 (three DVDs out at a time, no monthly limits); browse Blockbuster's library of 85,000 titles; place orders; and obtain movies from Blockbuster via mail delivery. Blockbuster's Total Access Premium plans allowed subscribers to go to a local Blockbuster store and exchange DVDs received by mail for unlimited free in-store movie rentals; Blockbuster Total Access plans entailed two, three, or five free in-store exchanges per month; Blockbuster's by-mail-only plans (with fees from $3.99 to $15.99 per month) called for in-store exchange fees of $1.99 per movie. To induce subscription upgrades, some mail-only subscribers received free in-store rental coupons each month, which could be used toward movie or video game rentals. As of January 2008, Blockbuster had 2.2 million online subscribers, of whom 2.0 million were paying subscribers and 200,000 were free-trial subscribers—all new subscribers were eligible for a free three-week trial.
- Purchasing the membership interests of Movielink, an online movie downloading service owned and operated by a group of movie studios. Movielink had one of the largest libraries of digital content for both rental and sale. Movielink's offerings were integrated into Blockbuster's Web site, giving Blockbuster expanded capability to sell or rent movies and deliver them in digital files (which was a considerably cheaper delivery method for Blockbuster than paying the postage for outgoing DVD orders and incoming DVD returns). Downloaded movies that were rented could be stored for up to 30 days and watched as many times as desired during a 24-hour viewing period that commenced when "Play Movie" was clicked. No subscription, membership, or late fees were charged on downloadable movie rentals from the Movielink library.

Recent sales data indicated that these actions were having a positive effect. Sales at Blockbuster stores had, on average, risen for four consecutive quarters, starting in the second quarter of 2007 and continuing through the second quarter of 2008. Most of the sales gains were in merchandise rather than rentals, however. In the first six months of 2008, rental revenues were $1.575 billion (versus $1.564 billion for the first six months of 2007), while merchandise sales climbed from $201 million in the first half of 2007 to $266 million in the first half of

2008. Moreover, the sales improvement at the company's stores was due in part to recent closures and sales of underperforming stores.

BROADENING THE PRODUCT OFFERINGS AT BLOCKBUSTER STORES Believing that the company's store network represented a huge competitive advantage, in 2008 Blockbuster executives initiated actions to transform Blockbuster stores into media entertainment destinations. One initiative was to expand the selection of movie DVDs offered for sale. Another initiative was to add a variety of entertainment-related services and products, including video game consoles (PlayStation 3, Xbox 360, Wii, and various handheld devices); a bigger selection of video games for both sale and rental; video game accessories; Discovery Channel products; and products related to hit movies (like Indiana Jones and Batman movies). To help consumers better appreciate the dramatic visual and audio improvements of Blu-ray technology and its high-definition format, during 2008 Blockbuster installed Blu-ray demonstration and sales kiosks in almost all of its U.S. and Canadian stores—the goal was to make Blockbuster the preferred destination for Blu-ray players/recorders and Blu-ray DVDs.

Early in 2008, Blockbuster entered into an agreement to acquire electronics retailer Circuit City—a move seen by top Blockbuster executives as a way to offer consumers a complete set of entertainment solutions; however, in July 2008, Blockbuster had to cancel the planned acquisition due to inability to secure adequate financing.

EXPANDING DIGITAL CONTENT DELIVERY Although digital delivery of movies was still a small market, Blockbuster was actively exploring a variety of ways to give customers a convenient way to access digitally delivered content from Blockbuster. The acquisition of Movielink and subsequent integration of Movielink's movie library into Blockbuster's online offerings gave customers the option to download movies to rent or own. But Blockbuster management saw this as only a significant first step toward giving customers a single interface—www.blockbuster.com—to reserve an in-store movie, rent movies for mail delivery, download content to a PC or portable device, and eventually access Blockbuster digital content directly through television sets. Ultimately, what was needed was an electronic device that enabled customers to view high-definition digital content from Blockbuster on their big-screen TVs. Management was actively working to achieve this capability, but as of fall 2008 Blockbuster had not announced when such a device would be available. The ultimate goal was to provide "whenever, wherever" viewing solutions to customers.

PROVIDING CONVENIENT ACCESS TO MEDIA CONTENT Senior Blockbuster executives believed that the company's capability to deliver entertainment content to consumers through its stores, by mail, DVD vending machines, digital downloading kiosks, and online downloads put it in an advantageous competitive position in 2008 compared to other media content providers. No other media provider could provide entertainment content to consumers through as many channels as Blockbuster. According to Jim Keyes, "We believe our distinct competitive advantage and our platform for future profitable growth will be our ability to provide convenient access to physical and electronic media entertainment all under the Blockbuster brand."

Blockbuster's Advertising and Marketing Strategy

Blockbuster relied on in-store conversations with store personnel, in-store signage, direct mail, e-mail, and online advertising to get its messages across to people coming to its stores, help increase store traffic, and acquire new subscribers. Management saw e-mail marketing as a cost-effective and efficient communications channel for building customer awareness and loyalty and boosting shopper traffic in its stores. New and reactivated customers were sent in-store offers. In-store signage and brochures were used to support relevant talking points by store customer service representatives. Store personnel were provided scripts designed to help them up-sell, cross-sell, engage store shoppers, increase transactions, and promote return visits.

A series of e-mail communications to Blockbuster Total Access subscribers was created to encourage in-store purchases during subscribers' in-store DVD exchange visits; these messages were customized according to in-store spend history, last store visit date, and other behaviors. Online subscribers received e-mails intended to educate new members, reinforce membership benefits, inform members of new features and offerings, and offer recommendations for movies to add to their queues.

During 2007, Blockbuster's advertising focus was on attracting more online rental subscribers. In 2008, advertising efforts were aimed at promoting greater hit title availability in stores, growing revenues in the video game category, informing customers of new product introductions, announcing special traffic-driving promotions, and acquiring and retaining Total Access members. Blockbuster used cooperative advertising funds from the studios to promote new DVD releases via direct mail and in-store signage.

Blockbuster's advertising expenditures were \$252.7 million in 2005, \$154.3 million in 2006, \$194.0 million in 2007, and \$43.9 million in the first six months of 2008 (versus \$108.3 million in the first six months of 2007).

Blockbuster'sP urchasing and Inventory Strategy

In purchasing movie and video game DVDs for rental, Blockbuster sought to craft an arrangement with each individual studio or game publisher aimed at acquiring sufficient copies to satisfy customer demand for the studio's titles while still holding down the overall costs of purchasing those titles for inventory. In some instances, Blockbuster's strategy for a given studio or game publisher entailed purchasing rental inventory on a title-by-title basis. In other instances, Blockbuster negotiated a revenue-sharing arrangement whereby in return for a lower price per copy, Blockbuster paid the studio/game publisher a percentage of rental revenues earned from its titles. The revenue-sharing payments became due and payable as the rental revenues were earned. In addition to the revenue-sharing component, most arrangements also provided for the method of disposition of the product at the conclusion of the rental cycle and/or additional payments for the early sale of unreturned product that was automatically purchased by the customer.

While the terms of revenue-sharing arrangements were generally similar for rental movie and game software inventory, revenue-sharing arrangements for domestic rental movies were generally negotiated for all titles released during the term of the contract, while revenue-sharing arrangements for rental game software were generally negotiated on a title-by-title basis. Approximately 82 percent of Blockbuster's domestic movie rental units were purchased under revenue-sharing arrangements in 2006 and 2007. The number of domestic game software rental inventory units purchased under revenue-sharing arrangements increased from 53 percent in 2006 to 58 percent in 2007.

Distribution and Inventory Management

All movies and games for Blockbuster's U.S. company-operated stores were delivered to the company's highly automated 850,000-square-foot distribution center in McKinney, Texas, which employed 785 people. At the McKinney facility, incoming copies of new movies and games were mechanically repackaged to make them suitable for rental at Blockbuster stores. The repackaged products were shipped to delivery agents scattered across the United States for distribution to nearby Blockbuster stores. In 2008, Blockbuster was exploring ways to improve the efficiency of its distribution system, including the potential of outsourcing all distribution activities.

In addition to the McKinney distribution center, in 2008 Blockbuster had 39 distribution centers spread strategically throughout the United States to support its by-mail subscription service. To expedite the delivery of rental DVDs to by-mail customers by the U.S. Postal Service, Blockbuster transported packaged DVDs from the distribution centers to 85 mail entry points, enabling one-business-day delivery to more than 90 percent of its online subscribers. Each distribution center operated 16 hours a day, five days a week, and employed approximately 35 people, including one distribution center manager.

Endnotes

[1] Cited by Blockbuster CEO James F. Keyes at Blockbuster's annual shareholders' meeting on May 28, 2008; AMR's market size estimate for 2004 was cited in Sarah McBride, Peter Grant, and Merissa Marr, "Movies May Hit DVD Cable Simultaneously," *The Wall Street Journal,* January 4, 2006, p. B1.

[2] Based on information in Shane C. Buettner, "DVD Sales Peaking," posted at Ultimate AV, www.guidetohometheater.com (accessed December 29, 2005).

Case 5

Dell Inc. in 2008: Can It Overtake Hewlett-Packard as the Worldwide Leader in Personal Computers?

Arthur A. Thompson
The University of Alabama

John E. Gamble
University of South Alabama

In 1984, at the age of 19, Michael Dell invested $1,000 of his own money and founded Dell Computer with a simple vision and business concept—that personal computers (PCs) could be built to order and sold directly to customers. Michael Dell believed his approach to the PC business had two advantages: (1) Bypassing distributors and retail dealers eliminated the markups of resellers, and (2) building to order greatly reduced the costs and risks associated with carrying large stocks of parts, components, and finished goods. Between 1986 and 1993, the company worked to refine its strategy, build an adequate infrastructure, and establish market credibility against better-known rivals. In the mid-to-late 1990s, Dell's strategy started to click into full gear. By 2003, Dell's sell-direct and build-to-order business model and strategy had provided the company with the most efficient procurement, manufacturing, and distribution capabilities in the global PC industry and given Dell a substantial cost and profit margin advantage over rival PC vendors.

During 2004–2005, Dell overtook Hewlett-Packard (HP) to become the global market leader in PCs. But Dell's global leadership proved short-lived; HP, energized by a new CEO who engineered a revitalized strategy, dramatically closed the gap on Dell in 2006 and regained the global market share lead by a fairly wide margin in 2007—winning an 18.8 percent global share versus Dell's 14.9 percent. In the United States, Dell also struggled to fend off a resurgent HP during 2006–2007. Whereas Dell had a commanding 33.6 percent share of PC sales in the United States in 2005, comfortably ahead of HP (19.5 percent) and far outdistancing Apple, Acer, Toshiba, Gateway, and Lenovo/IBM, Dell's U.S. share had slipped to 28.0 percent by the end of 2007, while HP's share was up to 23.9 percent. Exhibit 1 shows the shifting domestic and global sales and market share rankings in PCs during 1998–2007.

Since the late 1990s, Dell had also been driving for industry leadership in servers. In the mid-to-late 1990s, a big fraction of the servers sold were proprietary machines running on customized Unix operating systems and carrying price tags ranging from $30,000 to $1 million or more. But a seismic shift in server technology, coupled with growing cost-consciousness on the part of server users, produced a radical shift away from more costly, proprietary, Unix-based servers during 1999–2004 to low-cost x86 machines that were based on standardized components and technology, ran on either Windows or Linux operating systems, and carried price tags below $10,000. Servers with these characteristics fit Dell's strategy and capabilities perfectly,

Exhibit 1

U.S. and Global Market Shares of Leading PC Vendors, 1998–2007

A. U.S. Market Shares of the Leading PC Vendors, 1998–2007

		2007		2006		2005		2004		2002		2000		1998	
2007 RANK	VENDOR	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE
1	Dell	19,645	28.0%	20,472	31.2%	21,466	33.6%	19,296	33.7%	13,324	27.9%	9,645	19.7%	4,799	13.2%
2	Hewlett-Packard[1]	16,759	23.9	11,600	21.5	12,456	19.5	11,600	20.3	8,052	16.8	5,630	11.5	2,832	7.8
	Compaq[1]	—	—	—	—	—	—	—	—	—	—	7,761	15.9	6,052	16.7
3	Apple	4,081	5.8	3,109	4.7	2,555	4.0	1,935	3.3	1,693	3.5	n.a.	n.a.	n.a.	n.a.
4	Acer[2]	3,860	5.5	1,421	2.2	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
5	Toshiba	3,509	5.0	2,843	4.3	2,327	3.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Gateway	—	—	n.a.	n.a.	n.a.	n.a.	2,945	5.1	2,725	5.7	4,237	8.7	3,039	8.4
	Lenovo/ IBM[3]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	2,932	5.0	2,531	5.3	2,668	5.5	2,983	8.2
	Others	22,235	31.7	23,350	35.7	25.070	39.2	24,425	33.6	19,514	40.8	18,959	38.8	16,549	45.6
	All vendors	70,088	100.0%	65,481	100.0%	63,874	100.0%	57,256	100.0%	47,839	100.0%	48,900	100.0%	36,254	100.0%

B. Worldwide Market Shares of the Leading PC Vendors, 1998–2007[4]

		2007		2006		2005		2004		2002		2000		1998	
2007 RANK	VENDOR	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE	SHIPMENTS (IN 000s)	MARKET SHARE
1	Hewlett Packard[1]	50,526	18.8%	38,838	16.5%	32,575	15.7%	28,063	15.8%	18,432	13.6%	10,327	7.4%	5,743	6.3%
—	Compaq[1]	—	—	—	—	—	—	—	—	—	—	17,399	12.5	13,266	14.5
2	Dell	39,993	14.9	39,094	16.6	37,755	18.2	31,771	17.9	20,672	15.2	14,801	10.6	7,770	8.5
3	Acer[2]	21,206	7.9	13,594	5.8	9,845	4.7	6,461	3.6	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
4	Lenovo/ IBM[3]	20,224	7.5	16,609	7.1	12,979	6.2	10,492	5.9	8,292	6.2	9,308	6.7	7,946	8.7
5	Toshiba	10,936	4.1	9,292	3.9	7,234	3.5	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
	Others	126,075	46.9	117,971	50.1	107,450	51.7	100,693	52.7	73,237	54.9	80,640	58	50,741	55.5
	All Vendors	268,960	100.0%	235,397	100.0%	207,837	100.0%	177,480	100.0%	133,466	100.0%	139,057	100.0%	91,442	100.0%

n.a. = not available; sales and market shares for these companies in the years where n.a. appears are included in the "Others" category because the company was not in the top five in shipments or market share.

[1] Compaq was acquired by Hewlett-Packard in May 2002. The 2002 data for Hewlett-Packard include both Compaq-branded and Hewlett-Packard-branded PCs for the last three quarters of 2002 plus only Hewlett-Packard-branded PCs for Q1 2002. Compaq's worldwide PC shipments during Q1 2002 were 3,367,000; its U.S. PC shipments during Q1 2002 were 1,280,000 units. Compaq's line of PCs were later rebranded and absorbed into Hewlett-Packard PC offerings.

[2] Acer acquired Gateway in 2007. Data for Acer include shipments for Gateway starting in Q4 2007, and only Acer data for prior periods.

[3] Lenovo, a Chinese computer company, completed the acquisition of IBM's PC business in the second quarter of 2005 (the deal was made in December 2004). The numbers for Lenovo/IBM for 1998–2004 reflect sales of IBM branded PCs only; the numbers for 2005–2007 reflect their combined sales beginning in the second quarter of 2005. In 2007, Lenovo rebranded all IBM PCs as Lenovo.

[4] The worldwide market share data include branded shipments only and exclude sales of units carrying the brands of other PC producers and marketers; shipments of Compaq PCs for last three quarters of 2002 are included in 2002 figures for Hewlett-Packard due to HP's acquisition of Compaq.

Source: International Data Corporation.

and the company seized on the opportunity to use its considerable resources and capabilities in making low-cost, standard-technology PCs to go after the market for low- and mid-range x86 servers in a big way. During 2004–2007, Dell reigned as the number one domestic seller of x86 servers for Windows and Linux (based on unit volume), with just over a 30 percent market share (up from about 3–4 percent in the mid-1990s). Dell ranked number two in the world in x86 server shipments during this same period, with market shares in the 24–26 percent range, which put it in position to contend with HP for global market leadership.

In addition, Dell was making market inroads in other product categories. Its sales of data storage devices had grown to nearly $2.5 billion annually, aided by a strategic alliance with EMC, a leader in data storage. In 2001–2002, Dell began selling low-cost, data-routing switches—a product category where Cisco Systems was the dominant global leader. Starting in 2003, Dell began marketing Dell-branded printers and printer cartridges, product categories that provided global leader HP with the lion's share of its profits; as of 2008, Dell's sales of printers and printer supplies were believed to exceed $3 billion. Also in 2003, Dell began selling flat-screen LCD TVs and retail-store systems, including electronic cash registers, specialized software, services, and peripherals required to link retail-store checkout lanes to corporate information systems. Dell's MP3 player, the Dell DJ, was number two behind the Apple iPod. Dell added plasma screen TVs to its TV product line in 2004. Since the late 1990s, Dell had been marketing CD and DVD drives, printers, scanners, modems, monitors, digital cameras, memory cards, data storage devices, and speakers made by a variety of manufacturers.

So far, Dell's foray into new products and businesses had, in most cases, proved to be profitable—for a time, Dell sold handheld PC devices, an MP3 player (called the Dell DJ) that competed against the Apple iPod, and big-screen TVs, but these products were abandoned when profits proved elusive. According to Michael Dell, "We believe that all our businesses should make money. If a business doesn't make money, if you can't figure out how to make money in that business, you shouldn't be in that business."[1] Dell products were sold in more than 170 countries, but sales in 60 countries accounted for about 95 percent of total revenues.

Company Background

At age 12, Michael Dell was running a mail order stamp-trading business, complete with a national catalog, and grossing $2,000 a month. At 16 he was selling subscriptions to the *Houston Post,* and at 17 he bought his first BMW with money he had earned. He enrolled at the University of Texas in 1983 as a premed student (his parents wanted him to become a doctor), but he soon became immersed in computers and started selling PC components out of his college dormitory room. He bought random-access memory (RAM) chips and disk drives for IBM PCs at cost from IBM dealers, who at the time often had excess supplies on hand because they were required to order large monthly quotas from IBM. Dell resold the components through newspaper ads (and later through ads in national computer magazines) at 10–15 percent below the regular retail price.

By April 1984, sales were running about $80,000 per month. Dell decided to drop out of college and form a company, PCs Ltd., to sell both PC components and PCs under the brand name PCs Limited. He obtained his PCs by buying retailers' surplus stocks at cost, then powering them up with graphics cards, hard disks, and memory before reselling them. His strategy was to sell directly to end users; by eliminating the retail markup, Dell's new company was able to sell IBM clones (machines that copied the functioning of IBM PCs using the same or similar components) about 40 percent below the price of IBM's best-selling PCs. The discounting strategy was successful, attracting price-conscious buyers and generating rapid revenue growth. By 1985, the company was assembling its own PC designs with a few people working on six-foot tables. The company had 40 employees, and Michael Dell worked 18-hour days, often sleeping on a cot in his office. By the end of fiscal 1986, sales had reached $33 million.

During the next several years, however, PCs Limited was hampered by growing pains—specifically, a lack of money, people, and resources. Michael Dell sought to refine the company's business model; add needed production capacity; and build a bigger, deeper management staff and corporate infrastructure while at the same time keeping costs low. The company was renamed Dell Computer in 1987, and the first international offices were opened that same year. In 1988, Dell added a sales force to serve large customers, began selling to government agencies, and became a public company—raising $34.2 million in its first offering of common stock. Sales to large customers quickly became the dominant part of Dell's business. By 1990, Dell Computer had sales of $388 million, a market share of 2–3 percent, and an R&D staff of more than 150 people. Michael Dell's vision was for Dell Computer to become one of the top three PC companies.

Thinking its direct sales business would not grow fast enough, in 1990–93, the company began distributing its computer products through Soft Warehouse Superstores (now CompUSA), Staples (a leading office products chain), Walmart, Sam's Club, and Price Club (which merged with Costco in 1993). Dell also sold PCs through Best Buy stores in 16 states and through Xerox in 19 Latin American countries. But when the company learned how thin its margins were in selling through such distribution channels, it realized it had made a mistake and withdrew from selling to retailers and other intermediaries in 1994 to refocus on direct sales. At the time, sales through retailers accounted for only about 2 percent of Dell's revenues.

In 1993, further problems emerged: Dell reportedly lost $38 million in risky foreign-currency hedging, quality difficulties arose with certain PC lines made by the company's contract manufacturers, profit margins declined, and buyers were turned off by the company's laptop PC models. To get laptop sales back on track, the company took a charge of $40 million to write off its laptop line and suspended sales of laptops until it could get redesigned models into the marketplace.

Because of higher costs and unacceptably low profit margins in selling to individuals and households, Dell did not pursue the consumer market aggressively until sales to individuals at the company's Internet site took off in 1996 and 1997. It became clear that PC-savvy individuals, who were buying their second and third computers, wanted powerful computers with multiple features; did not need much technical support; and liked the convenience of buying direct from Dell, ordering a PC configured exactly to their liking, and having it delivered to their door within a matter of days. In early 1997, Dell created an internal sales and marketing group dedicated to serving the individual consumer segment and introduced a product line designed especially for home and personal use.

By late 1997, Dell had become a low-cost leader among PC vendors by wringing greater and greater efficiency out of its direct sales and build-to-order business model. Since then, the company had continued driving hard to reduce its costs by closely partnering with key suppliers to drive costs out of its supply chain and by incorporating e-commerce technology and use of the Internet into its everyday business practices. Throughout 2002–2007, Dell was widely regarded as the lowest-cost producer among all the leading vendors of PCs and servers worldwide. Moreover, its products were highly regarded; in 2007, Dell products received more than 400 awards relating to design, quality, and innovation—this was the largest number of product awards for a single year in the company's history.

In its 2008 fiscal year, Dell posted revenues of $61.1 billion and profits of nearly $3.0 billion. It ranked number 34 on *Fortune*'s list of the 500 largest U.S. corporations for 2007. In 2008, Dell had approximately 88,200 employees worldwide, up from 16,000 at year-end 1997; more than 66 percent of Dell's employees were located in countries outside the United States, and this percentage was growing. The company's headquarters and main office complex was in Round Rock, Texas (an Austin suburb). Its name had been changed from Dell Computer to Dell Inc. in 2003 to reflect the company's growing business base outside of PCs. Exhibits 2 and 3 provide information about Dell's financial performance and geographic operations.

MichaelD ell

In the company's early days Michael Dell hung around mostly with the company's engineers. He was so shy that some employees thought he was stuck up because he never talked to them. But people who worked with him closely described him as a likable young man who was slow to warm up to strangers.[2] He was a terrible public speaker and wasn't good at running meetings. But Lee Walker, a 51-year-old venture capitalist brought in by Michael Dell to provide much-needed managerial and financial experience during the company's organization-building years, became Michael Dell's mentor, built up his confidence, and was instrumental in turning him into a polished executive.[3] Walker served as the company's president and chief operating officer from 1986 to 1990; he had a fatherly image, knew everyone by name, and played a key role in implementing Michael Dell's marketing ideas. Under Walker's tutelage, Michael Dell became intimately familiar with all parts of the business, overcame his shyness, learned to control his ego, and turned into a charismatic leader with an instinct for motivating people and winning their loyalty and respect.

When Walker had to leave the company in 1990 for health reasons, Dell turned to Morton Meyerson, former CEO and president of Electronic Data Systems, for advice and guidance on how to transform Dell Computer from a fast-growing medium-sized company into a billion-dollar enterprise. Though sometimes given to displays of impatience, Michael Dell usually spoke in a quiet, reflective manner and came across as a person with maturity and seasoned judgment far beyond his age. His prowess was based more on an astute combination of technical knowledge and marketing know-how than on being a technological wizard. In 1992, at the age of 27, Michael Dell became the youngest CEO ever to head a Fortune 500 company; he was a billionaire at the age of 31.

By the late 1990s, Michael Dell had become one of the most respected executives in the PC industry. Journalists had described him as "the quintessential American entrepreneur" and "the most innovative guy for marketing computers." He was a much-sought-after speaker at industry and company conferences. His views and opinions about the future of PCs, the Internet, and e-commerce practices carried considerable weight both in the PC industry and among executives worldwide. Once pudgy and bespectacled, in early 2008, 43-year-old Michael Dell was physically fit, considered good-looking, wore contact lenses, ate only health foods, and lived in a three-story 33,000-square-foot home on a 60-acre estate in Austin, Texas, with his wife and four children. In 2008, he owned about 10 percent of Dell's common stock, worth about $4.3 billion.

Michael Dell was considered a very accessible CEO and a role model for young executives because he had done what many of them were trying to do. He delegated authority to subordinates, believing that the best results came from "turning loose talented people who can be relied upon to do what they're supposed to do." Business associates viewed Michael Dell as an aggressive personality, an extremely competitive risk taker who had always played close to the edge. He spent about 30 percent of his time traveling to company operations and meeting with customers. In a typical year, he would make two or three trips to Europe and two trips to Asia.

In mid-2004, Michael Dell, who had been the company's first and only CEO, transferred his title of CEO to Kevin Rollins, the company's president and chief operating officer. Dell remained as chairman of the board. Dell and Rollins had run the company for the past seven years under a shared leadership structure. The changes were primarily ones of title, not of roles

Exhibit 2

Selected Financial Statement Data for Dell Inc., Fiscal Years 2000–2008 (in millions, except per share data)

	FISCAL YEAR ENDED						
	FEBRUARY 1, 2008	FEBRUARY 2, 2007	FEBRUARY 3, 2006	JANUARY 28, 2005	JANUARY 30, 2004	FEBRUARY 1, 2002	JANUARY 28, 2000
Results of Operations							
Net revenue	$61,133	$57,420	$55,788	$49,121	$41,327	$31,168	$25,265
Cost of revenue	49,462	47,904	45,897	40,103	33,764	25,661	20,047
Gross margin	11,671	9,516	9,891	9,018	7,563	5,507	5,218
Gross profit margin	19.1%	16.6%	17.7%	18.4%	18.3%	17.7%	20.7%
Operating expenses:							
Selling, general and administrative[a]	7,538	5,948	5,051	4,352	3,604	2,784	2,387
Research, development and engineering[b]	693	498	458	460	434	452	374
Special charges	—	—	—	—	—	482	194
Total operating expenses	8,231	6,446	5,509	4,812	4,038	3,718	2,955
Total operating expenses as a % of net revenues	13.5%	11.2%	9.9%	9.8%	9.8%	10.4%[c]	10.9%[c]
Operating income	3,440	3,070	4,382	4,206	3,525	1,789	2,263
Operating profit margin	5.6%	5.3%	7.9%	8.6%	8.5%	5.7%	9.0%
Investment and other income (loss), net	387	275	26	197	186	(58)	188
Income before income taxes, extraordinary loss, and cumulative effect of change in accounting principle	3,827	3,345	4,608	4,403	3,711	1,731	2,451
Provision for income taxes	880	762	1,006	1,385	1,086	485	785
Net income	$ 2,947	$ 2,583	$ 3,602	$ 3,018	$ 2,625	$ 1,246	$ 1,666
Net profit margin	4.8%	5.8%	6.5%	6.1%	6.4%	4.0%	6.6%
Earnings per common share: Basic	$1.33	$1.15	$1.50	$1.20	$1.02	$0.48	$0.66
Diluted	$1.31	$1.14	$1.47	$1.18	$1.01	$0.46	$0.61
Weighted average shares outstanding: Basic	2,223	2,255	2,403	2,509	2,565	2,602	2,536
Diluted	2,247	2,271	2,449	2,568	2,619	2,726	2,728
Cash Flow and Balance Sheet Data							
Net cash provided by operating activities	$ 3,949	$ 3,969	$ 4,751	$ 5,821	$ 3,670	$ 3,797	$ 3,926
Cash, cash equivalents, and short-term investments	7,972	10,298	9,070	9,807	11,922	8,287	6,853
Total assets	27,561	25,635	23,252	23,215	19,311	13,535	11,560
Long-term debt	362	569	625	505	505	520	508
Total stockholders' equity	3,735	4,328	4,047	6,485	6,280	4,694	5,308

[a] Includes stock-based compensation expenses for fiscal years 2007 and 2008, pursuant to Statement of Financial Accounting Standards No. 123.

[b] Includes one-time in-process research and development charges of $83 million related to companies acquired by Dell during fiscal 2008.

[c] Excluding special charges.

Sources: Dell Inc., 10-K reports, 2002, 2005–2008.

Exhibit 3

Dell's Geographic Area Performance, Fiscal Years 2000–2008 (in millions)

	FEBRUARY 1, 2008	FEBRUARY 2, 2007	FEBRUARY 3, 2006	JANUARY 28, 2005	JANUARY 30, 2004	FEBRUARY 1, 2002	JANUARY 28, 2000
Net revenues							
Americas							
Business	$31,144	$29,311	$28,365	$25,289	$21,824	$17,275	$15,160
U.S. consumer	6,244	7,069	7,960	7,614	6,696	4,485	2,719
Total Americas	37,368	36,380	36,325	32,903	28,520	21,760	17,879
Europe/Middle East/Africa	15,267	13,682	12,887	10,753	8,472	6,429	5,590
Asia-Pacific/Japan	8,498	7,358	6,576	5,465	4,335	2,979	1,796
Total net revenues	$61,133	$57,420	$55,788	$49,121	$41,444	$31,168	$25,265
Operating income							
Americas							
Business	$ 2,549	$ 2,388	$ 2,956	$ 2,534	$ 2,229	$ 1,482	$ 1,800
U.S. consumer	(59)	135	452	414	373	260	204
Total Americas	2,490	2,523	3,408	2,948	2,602	1,742	2,004
Europe/Middle East/Africa	1,009	583	871	815	614	377	359
Asia-Pacific/Japan	471	332	524	443	309	152	94
Special charges	(530)	(368)	(421)	—	—	(482)	(194)
Total operating income	$3,440	$3,070	$4,382	$4,206	$3,525	$1,789	$2,263

Sources: Dell Inc., 10-K reports, 2002, 2005 and 2008; financial data posted at www.dell.com (accessed May 6, 2008).

or responsibilities. But when the company's performance stalled in 2006, Kevin Rollins was relieved of his responsibilities and Michael Dell reassumed the title of CEO (and continued in the role of chairman of the company's board of directors).

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In orchestrating Dell Inc.'s rise to global prominence, company executives had come to believe strongly that four tenets were the key to delivering superior customer value:[4]

1. Selling direct to customers is the most efficient way to market the company's products because it eliminates wholesale and retail dealers that impede Dell's understanding of customer needs and expectations and that add unnecessary time and cost.
2. Allowing customers to purchase custom-built products and custom-tailored services is the most effective way to meet customer needs.
3. A highly efficient supply chain and manufacturing organization, grounded in the use of standardized technologies and selling direct, paves the way for a low-cost structure where cost savings can be passed along to customers in the form of lower prices.

4. Dell can deliver added value to customers by (1) researching all the technological options, (2) trying to determine which ones are "optimal" in the sense of delivering the best combination of performance and efficiency, and (3) being accountable to customers for helping them obtain the highest return on their investment in IT products and services. In almost all cases, non-proprietary, standardized technologies deliver the best value to customers.

With top management holding firmly to these tenets, Dell's strategy during the 2002–2007 period had seven core elements: (1) making build-to-order manufacturing progressively more cost-efficient, (2) partnering closely with suppliers to squeeze cost savings out of the supply chain, (3) using direct sales techniques to gain customers, (4) expanding into additional products and services to capture a bigger share of customers' IT spending, (5) providing good customer service and technical support, (6) keeping R&D and engineering activities focused squarely on better meeting the needs of customers, and (7) using standardized technologies in all product offerings.

The business model on which the strategy was predicated was straightforward: Continuously search for ways to reduce costs—the company's latest initiative was to reduce costs by $3 billion in 2008. Use the company's strong capabilities in supply chain management, low-cost manufacturing, and direct sales to grow sales and market share in both the PC and server segments and expand into product categories where Dell could provide added value to its customers in the form of lower prices. The standard pattern for entering new product categories was to identify an IT product with good margins; figure out how to build it (or else have it built by others) cheaply enough to be able to significantly underprice competitive products; market the new product to Dell's steadily growing customer base; and watch the market share points, incremental revenues, and incremental profits pile up.

Cost-Efficient Build-to-Order Manufacturing

Dell built the vast majority of its computers, workstations, and servers to order; only a small fraction was produced for inventory and shipped to wholesale or retail partners. Dell customers could order custom-equipped servers and workstations according to the needs of their applications. Desktop and laptop customers ordered whatever configuration of microprocessor speed, random-access memory, hard disk capacity, CD or DVD drives, fax/modem/wireless capabilities, graphics cards, monitor size, speakers, and other accessories they preferred. The orders were directed to the nearest factory. In 2008, Dell had assembly plants in Austin, Texas; Nashville, Tennessee; Winston-Salem, North Carolina; Limerick, Ireland; Xiamen, China; Penang, Malaysia; Hortolândia, Brazil; Chennai, India; and Lodz, Poland. In March 2008, the company announced that its desktop assembly plant in Austin, Texas, would be closed. The Winston-Salem plant was Dell's largest when it opened in 2005 and had the capacity to assemble 15,000 to 20,000 desktops per day—it could turn out a new PC every five seconds. Dell shipped about 140,000 products daily—about 1 every second. PCs, workstations, and servers were assembled at all locations; assembly of lower-volume products was concentrated in a more limited number of locations. All plants used much the same production systems and procedures. Typically, a plant had the capability to build and deliver a customer's order in three to five business days; however, the Winston-Salem plant could in most cases deliver orders to customers on the eastern coast of the United States in one to three business days. Dell believed in building its assembly plants close to customers because the labor costs to assemble a PC were about $10 whereas the logistics costs to move parts and ship a finished PC were about $40.[5]

ONGOING IMPROVEMENTS IN ASSEMBLY EFFICIENCY Until 1997, Dell operated its assembly lines in traditional fashion, with each worker performing a single operation. An order form accompanied each metal chassis across the production floor; drives, chips, and ancillary items were installed to match customer specifications. As a partly assembled PC arrived at a new workstation, the operator, standing beside a tall steel rack with drawers full of components, was instructed what to do by little red and green lights flashing beside the drawers. When the operator was finished, the component drawers were automatically replenished from the other side and the PC chassis glided down the line to the next workstation. However, Dell had reorganized its plants in 1997, shifting to "cell manufacturing" techniques whereby a team of workers operating at a group workstation (or cell) assembled an entire PC according to customer specifications. The shift to cell manufacturing reduced Dell's assembly times by 75 percent and doubled productivity per square foot of assembly space. Assembled computers were first tested and then loaded with the desired software, shipped, and typically delivered five to six business days after the order was placed.

Later, the cell manufacturing approach was gradually abandoned in favor of an even more efficient assembly-line approach that allowed workers to turn out close to 800 desktop PCs per hour on three assembly lines that took half the floor space of the cell manufacturing process, where production had run about 120 units per hour. Here the gains in assembly efficiency were achieved partly by redesigning the PCs to permit easier and faster assembly, partly by making innovations in the assembly process, and partly by reducing (by 50 percent) the number of times a computer was touched by workers during assembly and shipping. In 2005, it took about 66 minutes to assemble and test a PC. Moreover, just-in-time inventory practices that left pallets of parts sitting around everywhere had been tweaked to just-in-the-nick-of-time delivery by suppliers of the exact parts needed every couple of hours; double-decker conveyor belts moved parts and components to designated assembly points. Newly assembled PCs were routed on conveyors to shipping, where they were boxed and shipped to customers the same day.

Dell's new 750,000-square-foot plant in Winston-Salem featured a production layout that allowed computers to be tested as its components and software were installed. This "instantaneous build and test" operation permitted team members to identify and correct any problems on the spot rather than waiting until the PC was fully assembled. Workers at all Dell plants competed with one another to come up with more efficient assembly methods. Cost-saving assembly innovations pioneered in one Dell plant were quickly implemented worldwide.

Dell's latest cost-saving initiative was to move away from 100 percent configure-to-customer-order assembly to a mixture of fixed configurations (for components that rarely varied from order to order) and flexible configurations (for components that were subject to strong and varying customer preferences—like hard drive size, screen displays, amount of memory, graphics cards, type of microprocessor, and version of Windows operating system).

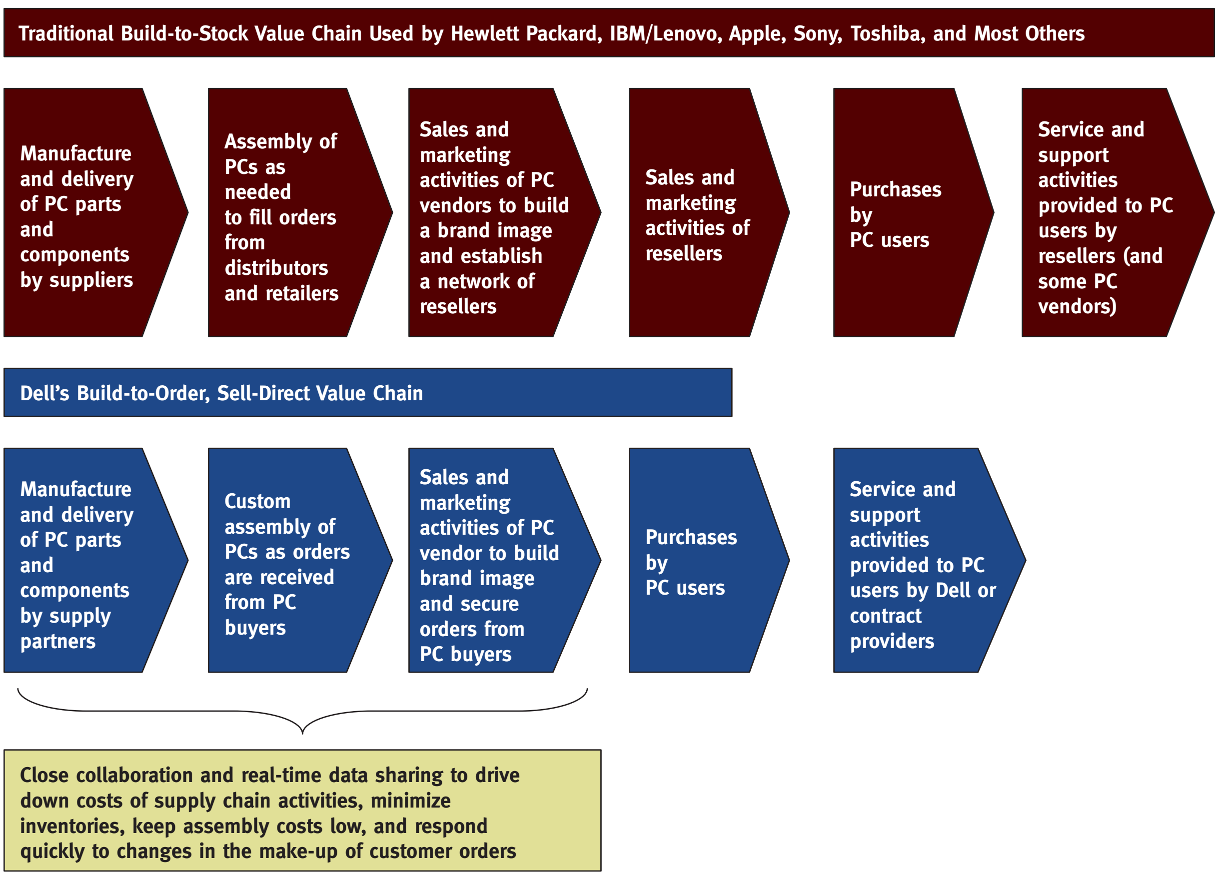
Dell was regarded as a world-class manufacturing innovator and a pioneer in how to mass-produce a customized product—its methods were routinely studied in business schools worldwide. Several of Dell's PC rivals—most notably Hewlett-Packard—had given up on trying to produce their own PCs as cheaply as Dell and shifted to outsourcing their PCs from contract manufacturers who specialized in PC assembly and often assembled a variety of PC brands. Dell management believed that its in-house manufacturing delivered about a 6 percent cost advantage versus outsourcing. Dell's build-to-order strategy meant that the company had only a tiny stock of finished goods inventories in-house and that, unlike competitors using the traditional value chain model, it did not have to wait for resellers to clear out their own inventories before it could push new models into the marketplace—resellers typically operated with 30 to 60 days inventory of prebuilt models (see Exhibit 4). Equally important was the fact that customers who bought from Dell got the satisfaction of having their computers customized to their particular liking and pocketbook.

QUALITY CONTROL All assembly plants had the capability to run testing and quality control processes on components, parts, and subassemblies obtained from suppliers, as well as on the finished products Dell assembled. Suppliers were urged to participate in a quality certification program that committed them to achieving defined quality specifications. Quality control activities were undertaken at various stages in the assembly process. In addition, Dell's quality control program included testing of completed units after assembly, ongoing production reliability audits, failure tracking for early identification of production and component problems associated with new models shipped to customers, and information obtained from customers through service and technical support programs. All of the company's plants had been certified as meeting ISO 9001:2000 standards. But while Dell's quality control program was first-rate, it was not perfect; in fiscal year 2008, Dell incurred special warranty cost charges of $307 million to service or replace certain desktop models that included a vendor part that failed to perform to specifications.

PARTNERSHIPS WITH SUPPLIERS Michael Dell believed that it made much better sense for the company to partner with reputable suppliers of PC parts and components than to integrate backward and get into parts and components manufacturing on its own. He explained why:

> If you've got a race with 20 players all vying to make the fastest graphics chip in the world, do you want to be the twenty-first horse, or do you want to evaluate the field of 20 and pick the best one?[6]

EXHIBIT 4 Comparative Value Chain Models of PC Vendors



Dell management evaluated the various makers of each component; picked the best one or two as suppliers; and then stuck with them as long as they maintained their leadership in technology, performance, quality, and cost. Management believed that long-term partnerships with reputable suppliers had at least five advantages. First, using name-brand processors, disk drives, modems, speakers, and multimedia components enhanced the quality and performance of Dell's PCs. Because of varying performance among different brands of components, the brand of the components was quite important to customers concerned about performance and reliability. Second, because Dell partnered with suppliers for the long term and because it committed to purchase a specified percentage of its requirements from each supplier, Dell was assured of getting the volume of components it needed on a timely basis even when overall market demand for a particular component temporarily exceeded the overall market supply. Third, Dell's long-run commitment to its suppliers made it feasible for suppliers to locate their plants or distribution centers within a few miles of Dell assembly plants, putting them in position to make deliveries daily or every few hours, as needed. Dell supplied data on inventories and replenishment needs to its suppliers at least once a day—hourly in the case of components being delivered several times daily from nearby sources.

Fourth, long-term supply partnerships facilitated having some of the supplier's engineers assigned to Dell's product design teams and being treated as part of Dell. When new products were launched, suppliers' engineers were stationed in Dell's plants; if early buyers called with a problem related to design, further assembly and shipments were halted while the supplier's engineers and Dell personnel corrected the flaw on the spot.[7] Fifth, long-term partnerships enlisted greater cooperation on the part of suppliers to seek new ways to drive costs out of the supply chain. Dell openly shared its daily production schedules, sales forecasts, and new model introduction plans with vendors. Dell also did a three-year plan with each of its key suppliers and worked with suppliers to minimize the number of different stock-keeping units of parts and components in its products and to identify ways to drive costs down.

COMMITMENT TO JUST-IN-TIME INVENTORY PRACTICES Dell's just-in-time inventory emphasis yielded major cost advantages and shortened the time it took for Dell to get new generations of its computer models into the marketplace. New advances were coming so fast in certain computer parts and components (particularly microprocessors, disk drives, and wireless devices) that any given item in inventory was obsolete in a matter of months, sometimes quicker. Moreover, rapid-fire reductions in the prices of components were not unusual—for example, Intel regularly cut the prices on its older chips when it introduced newer chips, and it introduced new chip generations about every three months. In 2003–2004, component costs declined an average of 0.5 percent weekly.[8] Michael Dell explained the competitive and economic advantages of minimal component inventories:

> If I've got 11 days of inventory and my competitor has 80 and Intel comes out with a new chip, that means I'm going to get to market 69 days sooner. In the computer industry, inventory can be a pretty massive risk because if the cost of materials is going down 50 percent a year and you have two or three months of inventory versus 11 days, you've got a big cost disadvantage. And you're vulnerable to product transitions, when you can get stuck with obsolete inventory.[9]

For a growing number of parts and components, Dell's close partnership with suppliers was allowing it to operate with no more than two hours of inventory.

In fiscal year 1995, Dell averaged an inventory turn cycle of 32 days. By the end of fiscal 1997 (January 1997), the average was down to 13 days. In fiscal 1998, Dell's inventory averaged 7 days, which compared very favorably with a 14-day average at Gateway, a 23-day average at then industry leader Compaq, and the estimated industrywide average of over 50 days.

In fiscal years 1999 and 2000, Dell operated with an average of six days' supply of production materials in inventory; the average dropped to five days' supply in fiscal year 2001, four days' supply in 2002, and 2.7 to four days' supply in fiscal years 2003–2007.

Dell's Direct Sales Strategy and Marketing Efforts

With thousands of phone, fax, and Internet orders daily and ongoing field sales force contact with customers, the company kept its finger on the market pulse, quickly detecting shifts in sales trends, design problems, and quality glitches. If the company got more than a few of the same complaints, the information was relayed immediately to design engineers who checked out the problem. When design flaws or components defects were found, the factory was notified and the problem corrected within a few days. Management believed Dell's ability to respond quickly gave it a significant advantage over PC makers that operated on the basis of large production runs of variously configured and equipped PCs and sold them through retail channels. Dell saw its direct sales approach as a totally customer-driven system, with the flexibility to transition quickly to new generations of components and PC models.

WEB SITE STRATEGY Dell's Web site was one of the world's highest volume Internet commerce sites, with nearly 500 million unique visitors, well over 1 billion visits, and close to 10 billion page requests annually. Dell began Internet sales at its Web site in 1995, almost overnight achieving sales of $1 million a day. Sales at its Web site reached $5 million daily in 1998, $35 million daily in 2000, and $60 million a day in 2004. By early 2003, over 50 percent of Dell's sales were Web-enabled—and the percentage trended upward through 2007. The revenues generated at the Web site were greater than those generated at Yahoo, Google, eBay, and Amazon combined.[10]

At the company's Web site, prospective buyers could review Dell's entire product line in detail, configure and price customized PCs, place orders, and track orders from manufacturing through shipping. The closing rate on sales at Dell's Web site was 20 percent higher than that on sales inquiries received via telephone. Management believed that enhancing www.dell.com to shrink transaction and order fulfillment times, increase accuracy, and provide more personalized content resulted in a higher degree of "e-loyalty" than traditional attributes like price and product selection.

DELL'S CUSTOMER-BASED SALES AND MARKETING FOCUS Whereas many technology companies organized their sales and marketing efforts around product lines, Dell was organized around customer groups. Dell had placed managers in charge of developing sales and service programs appropriate to the needs and expectations of each customer group. Until the early 1990s, Dell operated with sales and service programs aimed at just two market segments—high-volume corporate and governmental buyers and low-volume business and individual buyers. But as sales took off in 1995–1997, these segments were subdivided into finer, more homogeneous categories that by 2000 included global enterprise accounts, large and midsize companies (over 400 employees), small companies (under 400 employees), health care businesses (over 400 employees), federal government agencies, state and local government agencies, educational institutions, and individual consumers. Many of these customer segments were further subdivided—for instance, in education, there were separate sales and marketing programs for K–12 schools; higher education institutions; and personal-use purchases by faculty, staff, and students.

Dell had a field sales force that called on large business and institutional customers throughout the world. Dell's largest global enterprise accounts were assigned their own dedicated sales force—for example, Dell had a sales force of 150 people dedicated to meeting the needs of General Electric's facilities and personnel scattered across the world. Individuals and small businesses could place orders by telephone or at Dell's Web site. Dell had call centers in the United States, Canada, Europe, and Asia with toll-free lines; customers could talk with a sales representative about specific models, get information faxed or mailed to them, place an order, and pay by credit card. The Asian and European call centers were equipped with technology that routed calls from a particular country to a particular call center. Thus, for example, a customer calling from Lisbon, Portugal, was automatically directed to a Portuguese-speaking sales rep at the call center in Montpelier, France.

However, in some countries Dell's sell-direct-to-customers strategy put it at a disadvantage in appealing to small business customers and individual consumers, since most of these customers were reluctant to place orders by phone or over the Internet. Rivals in Japan and China who marketed PCs through retailers and other resellers were outselling Dell in the small business and household segments. According to an executive at Lenovo, one of Dell's biggest rivals in China, "It takes two years of a person's savings to buy a PC in China. And when two years of savings is at stake, the whole family wants to come out to a store to touch and try the machine."[11] To address the reluctance of households to buy direct from Dell, the head of Dell's consumer PC sales group in Japan installed 34 kiosks in leading electronics stores around Japan, allowing shoppers to test Dell computers, ask questions of staff, and place orders—close to half the sales were to people who did not know about Dell prior to visiting the kiosk. The kiosks proved quite popular and were instrumental in boosting Dell's share of PC sales to consumers in Japan.

Inspired by the success of kiosks in Japan, in 2002 Dell began installing Dell Direct Store kiosks in a variety of U.S. retail settings as a hands-on complement to Internet and phone sales. The kiosk stores showcased Dell's newest notebook and desktop computers, plasma and LCD TVs, printers, and music players. The kiosks did not carry inventory, but customers could talk face-to-face with a knowledgeable Dell sales representative, inspect Dell's products, and order them on the Internet while at the kiosk. The kiosks were considered a success in getting consumers to try Dell products. More kiosks were added and, by December 2005, Dell had 145 Dell Direct Store kiosks in 20 states, within reach of more than 50 percent of the U.S. population.

SUPPLEMENTING THE DIRECT SALES STRATEGY WITH SALES AT THE RETAIL STORES OF SELECT PARTNERS In fiscal 2006, Dell's share of PC sales to U.S. households dropped to 25.6 percent from 29.3 percent the prior year. In 2007, its share of the home or consumer market in the United States dropped even more precipitously, to 18.9 percent (see Exhibit 5). Sales to households weakened in other parts of the world market as well. The declines were partly due (1) to Hewlett-Packard's aggressive and successful efforts (mainly, lower pricing and better feature sets) to gain market share at Dell's expense and (2) to surging U.S. sales of Apple's PC models (see Exhibit 1), buoyed chiefly by consumer infatuation with Apple's iPod models and its new iPhone. Dell management responded to the unexpected and unprecedented falloff in sales to households by backing off on its almost 100 percent commitment to selling direct and forging partnerships with such retailers as Walmart, Staples, and Best Buy to begin offering select Dell PCs in retail stores. Similar initiatives to begin selling through retailers were taken in other parts of the world market. In Latin America, Dell forged retailing partnerships with Walmart and Pontofrio. Dell's retailing partners in Europe, the Middle East, and Africa included Carphone Warehouse, Carrefour, Tesco, and DSGi. In China, Japan, and other parts of the Asia-Pacific region, Dell began selling its PCs at the stores of Gome (the leading consumer electronics retailer in China), Suning, Hontu, HiMart, Courts, Croma, Officeworks (104 stores in Australia), and Bic Camera. By mid-2008, Dell had its products available in 12,000 retail stores worldwide and planned to grow this number considerably.

So far, Dell management was pleased with the initial results of its shift to using retail stores

Exhibit 5

Trends in Dell's Market Shares in PCs and x86 Servers, 1994–2007

MARKET SEGMENT	DELL'S MARKET SHARE 2007	2006	2005	2004	2002	2000	1998	1996	1994
Worldwide share by geographic area	14.9%	17.2%	18.2%	17.7%	14.9%	10.5%	8.0%	4.1%	2.7%
United States	29.3	31.3	33.6	33.1	28.0	18.4	12.0	6.4	4.2
Europe/Middle East/Africa	11.0	12.2	12.5	11.5	9.6	7.8	7.0	3.8	2.4
Asia-Pacific	8.9	8.8	8.2	7.0	4.8	3.4	2.4	1.3	0.3
Japan	14.0	14.2	12.3	11.3	7.7	4.0	3.0	1.6	1.1
Worldwide share by product									
Desktop PCs	15.0%	17.2%	18.2%	18.0%	14.8%	10.1%	7.8%	4.3%	3.0%
Notebook PCs	14.2	16.4	17.3	16.2	14.4	11.3	8.5	3.4	1.1
x86 Servers	25.0	25.6	26.3	24.8	21.7	15.4	9.7	3.4	3.1
U.S. segment share	29.3%	31.3%	33.1%	33.1%	28.0%	18.4%	12.0%	6.4%	4.2%
Education	40.7	43.8	44.6	44.3	34.9	26.2	11.0	3.9	1.1
Government	37.7	33.2	36.0	32.9	33.7	22.9	14.6	6.5	7.1
Home	18.9	25.6	29.3	29.7	22.7	6.5	3.5	2.1	1.2
Large business	43.3	43.7	43.3	44.2	39.9	31.3	21.6	11.2	6.9
Small/medium business	29.1	27.0	29.2	28.5	24.2	22.6	14.3	7.9	5.4

Source: Information posted at www.dell.com (accessed May 6, 2008).

as a way to supplement online and telephone sales to consumers and small businesses.

Expansion into New Products

In recent years, Dell had expanded its product offerings to include data storage hardware, switches, handheld PCs, printers, and printer cartridges, and software products in an effort to diversify its revenue stream and use its competitive capabilities in PCs and servers to pursue growth opportunities. Michael Dell explained why Dell had decided to expand into products and services that complemented its sales of PCs and servers:

> We tend to look at what is the next big opportunity all the time. We can't take on too many of these at once, because it kind of overloads the system. But we believe fundamentally that if you think about the whole market, it's about an $800 billion market, all areas of technology over time go through a process of standardization or commoditization. And we try to look at those, anticipate what's happening, and develop strategies that will allow us to get into those markets. In the server market in 1995 we had a 2 percent market, share; today we have over a 30 percent share; we're number 1 in the U.S. How did that happen? Well, first of all it happened because we started to have a high market share for desktops and notebooks. Then customers said, oh yes, we know Dell; those are the guys who have really good desktops and notebooks. So they have servers; yes, we'll test those; we'll test them around the periphery, maybe not in the most critical applications at first, but we'll test them here. [Then they discover] these are really good and Dell provides great support . . . and I think to some extent we've benefited from the fact that our competitors have underestimated the importance of value, and the power of the relationship and the service that we can create with the customer.

> And, also, as a product tends to standardize there's not an elimination of the requirement for custom services; there's a reduction of it. So by offering some services, but not the services of the traditional proprietary computer company, we've been able to increase our share. And, in fact, what tends to happen is customers embrace the standards, because they know that's going to save them costs. Let me give you an example . . . about a year ago we entered into the data networking market. So we have Ethernet switches, layer 2 switches. So if you have PCs and servers, you need switches; every PC attaches to a switch; every server attaches to a switch. It's a pretty easy sale; switches go along with computer systems. We looked at this market and were able to come up with products that are priced about 2½ times less than the market leader today, Cisco, and as a result the business has grown very, very quickly. We shipped 1.8 million switch ports in a period of about a year, when most people would have said that's not going to work and come up with all kinds of reasons why we can't succeed.[12]

As Dell's sales of data-routing switches accelerated in 2001–2002 and Dell management mulled over whether to expand into other networking products and Internet gear, Cisco elected to discontinue supplying its switches to Dell for resale as of October 2002. Dell's family of PowerConnect switches—simple commodity-like products generally referred to as layer 2 switches in the industry—were about 75 percent cheaper than those made by Cisco as of 2005.

Senior Dell executives saw external storage devices as a growth opportunity because the company's corporate and institutional customers were making increasing use of high-speed data storage and retrieval devices. Dell's PowerVault line of storage products had data protection and recovery features that made it easy for customers to add and manage storage and simplify consolidation. The PowerVault products used standardized technology and components (which were considerably cheaper than customized ones), allowing Dell to underprice rivals and drive down storage costs for its customers by about 50 percent. Dell's competitors in storage devices included Hewlett-Packard and IBM.

Some observers saw Dell's 2003 entry into the printer market as a calculated effort to go after Hewlett-Packard's biggest and most profitable business segment and believed the Dell offensive was deliberately timed to throw a wrench into HP's efforts to resolve the many challenges of successfully merging its operations with those of Compaq. One of the reasons Dell had entered the market for servers back in 1995 was that Compaq Computer, then its biggest rival in PCs, had been using its lucrative profits on server sales to subsidize charging lower prices on Compaq computers and thus be more price-competitive against Dell's PCs—at the time Compaq was losing money on its desktop and notebook PC business. According to Michael Dell:

> Compaq had this enormous profit pool that they were using to fight against us in the desktop and notebook business. That was not an acceptable situation. Our product teams knew that the servers weren't that complicated or expensive to produce, and customers were being charged unfair prices.[13]

Dell management believed that in 2000–2002 HP was doing much the same thing in printers and printer products, where it had a dominant market share worldwide and generated about 75 percent of its operating profits. Dell believed that HP was using its big margins on printer products to subsidize selling its PCs at prices comparable to Dell's, even though Dell had costs that were about 8 percent lower than HP's. HP's PC operations were either in the red or barely in the black during most of 2000–2003, while Dell consistently had profit margins of 8 percent or more on PCs. Dell management believed the company's entry into the printer market would add value for its customers. Michael Dell explained:

> We think we can drive down the entire cost of owning and using printing products. If you look at any other market Dell has gone into, we have been able to significantly save money for customers. We know we can do

> that in printers; we have looked at the supply chain all the way through its various cycles and we know there are inefficiencies there. I think the price of the total offering when we include the printer and the supplies . . . can come down quite considerably.[14]

When Dell announced it had contracted with Lexmark to make printers and printer and toner cartridges for sale under the Dell label beginning in 2003, HP immediately discontinued supplying HP printers to Dell for resale at Dell's Web site. Dell had been selling Lexmark printers for two years and, since 2000, had resold about 4 million printers made by such vendors as HP, Lexmark, and other vendors to its customers. Lexmark designed and made critical parts for its printers but used offshore contract manufacturers for assembly. Gross profit margins on printers (sales minus cost of goods sold) were said to be in single digits in 2002–2004, but the gross margins on printer supplies were in the 50–60 percent range—brand-name ink cartridges for printers typically ran $25 to $35. As of fall 2005, Dell had sold more than 10 million printers and had an estimated 20 percent of the market for color network lasers and color inkjet printers in the United States.[15]

Dell executives believed the company's entry and market success in printer products had put added competitive pressure on Hewlett-Packard in the printer market and was partly responsible for HP's share of the printer market worldwide slipping from just under 50 percent to around 46 percent in 2004. To further keep the pricing pressure on HP in 2003, Dell had priced its storage and networking products below comparable HP products.

Exhibit 6 shows a breakdown of Dell's sales by product category. Exhibit 7 shows Dell's average revenues per unit sold for fiscal years 1998–2008. The declines were driven by steadily falling costs for components, Dell's ability to improve productivity and take costs out of its value chain, and Dell's strategy of passing along cost savings to its customers and trying to deliver more value to customers than its rivals did. However, the tiny increases in average revenues per unit in the past two fiscal years reflected slowing declines in components prices, a shift in the PC sales mix away from desktops to laptops (which carried higher price tags and thus yielded greater average revenues per unit sold), and Dell's more restrained pricing (to protect its operating and net profit margins

Exhibit 6

Dell's Revenues by Product Category, 2006–2008

	2008		2007		2006	
PRODUCT CATEGORY	REVENUES (IN BILLIONS)	% OF TOTAL REVENUES	REVENUES (IN BILLIONS)	% OF TOTAL REVENUES	REVENUES (IN BILLIONS)	% OF TOTAL REVENUES
Desktop PCs	$19.6	32.1%	$19.8	34.5%	$21.6	38.7%
Mobility products (laptop PCs and workstations)	17.4	28.5	15.5	27.0	14.4	25.8
Software and peripherals (printers, monitors, TVs, projectors, ink and toner cartridges)	9.9	16.2	9.0	15.7	8.3	14.9
Servers and networking hardware	6.5	10.6	5.8	10.1	5.4	9.8
Consulting and enhanced services	5.3	8.8	5.1	8.9	4.2	7.5
Storage products	2.4	3.9	2.3	4.0	1.9	3.4
Totals	$61.1	100.1%	$57.4	100.2%	$55.8	100.1%

Note: Total revenue percentages may exceed 100% due to rounding up of revenue percentage data.
Source: Dell's 10-K report, fiscal 2008, p. 90.

Exhibit 7

Trend in Dell's Approximate Average Revenue per Unit Sold, Fiscal Years 1998–2008

FISCAL YEAR	DELL'S APPROXIMATE AVERAGE REVENUE PER UNIT SOLD
1998	$2,600
2000	2,250
2001	2,050
2002	1,700
2003	1,640
2004	1,590
2005	1,560
2006	1,500
2007	1,510
2008	1,540

Source: Company financial records and company postings at www.dell.com (accessed May 3, 2008).

from further erosion). In fiscal 2007–2008, unlike prior years, Dell had difficulty in lowering unit costs; out-of-proportion increases in operating expenses (see Exhibit 2) made it infeasible for Dell to cut prices and still preserve its operating profit margins. Top executives opted to maintain prices to keep the company's already lower operating profit margins from going down any further (see Exhibit 2); this left Dell vulnerable to HP's strategic offensive to regain sales and market share—an offensive that featured prices for HP products that were more in line with what Dell was charging.

CustomerS ervicean d Technical Support

Service became a feature of Dell's strategy in 1986 when the company began providing a year's free on-site service with most of its PCs after users complained about having to ship their PCs back to Austin for repairs. Dell began offering PC buyers the option of buying contracts for on-site repair services for a defined period (usually one to four years). Dell contracted with local service providers to handle customer requests for repairs; on-site service was provided on a four-hour basis to large customers and on a next-day basis to small customers. Dell generally contracted with third-party providers to make the necessary on-site service calls. Customers notified Dell when they had problems; such notices triggered two electronic dispatches—one to ship replacement parts from Dell's factory to the customer, and one to notify the contract service provider to prepare to make the needed repairs as soon as the parts arrived.[16] Bad parts were returned so that Dell could determine what went wrong and how to prevent such problems from happening again (problems relating to faulty components or flawed components design were promptly passed along to the relevant supplier for correction). If business or institutional customers preferred to work with their own service provider, Dell supplied the provider of choice with training and spare parts needed to service the customers' equipment.

Later, Dell began offering contracts for CompleteCare accidental damage service. In 2006, Dell began using an online diagnostics tool called DellConnect to troubleshoot and resolve problems with a customer's computer while the customer was connected to Dell's Web site. In 2007, Dell launched a corporate blog called Direct2Dell, a customer idea engine called IdeaStorm, and several online community forums for the purpose of better listening to and engaging with customers. Dell's online training programs featured more than 1,200 courses for consumer, business, and IT professionals. Over 50 percent of Dell's technical support and customer service activities were conducted via the Internet. Customers could also request technical support via a toll-free phone number and e-mail; Dell received more than 8 million phone calls and 500,000 to 600,000 e-mail messages annually requesting service and support.

Dell had 25 customer service centers worldwide in 2008 that were primarily engaged in handling technical support, requests for repairs, and other issues and inquiries. In a move to trim rising technical support and customer service costs in 2004–2005, Dell opted to move a large portion of its support services to countries where labor costs were low. But according to Dell's president of global services and chief information officer, "We did it way too quickly—we didn't move process management disciplines with it as effectively as we should have, and we wound up making some mistakes with the services experience."[17] The outcome was a sharp rise in customer complaints, especially among small business and individual customers who were most affected—a number of irritated Dell customers went so far as to post their horror stories at Web sites like IhateDell.net, and the resulting media publicity tarnished Dell's reputation for customer service among these buyers. To correct the service problems, Dell had moved many of its service centers back to countries where big numbers of its customers were located. Service processes were standardized worldwide, and best practices from all over the world were built into the standards. Dell's goal was to reach 90 percent customer satisfaction—where customers rated their service experience with Dell as "top notch" or "very satisfied"—as quickly as possible. In early 2008, Dell's customer satisfaction ratings were at 92 percent for Asia, at 90 percent in the Europe/ Middle East/Africa region, and in the 80 percent range for the Americas (these ratings included all services for small, medium, and large customers).[18]

PREMIER PAGES Dell had developed customized, password-protected Web sites called Premier Pages for more than 50,000 corporate, governmental, and institutional customers worldwide. These Premier Pages gave customers' personnel online access to information about all Dell products and configurations the company had purchased or that were currently authorized for purchase. Employees could use Premier Pages to (1) obtain customer-specific pricing for whatever machines and options the employee wanted to consider, (2) place an order online that would be routed electronically to higher-level managers for approval and then on to Dell for assembly and delivery, and (3) seek advanced help desk support. Customers could also search and sort all invoices and obtain purchase histories. These features eliminated paper invoices, cut ordering time, and reduced the internal labor customers needed to staff corporate purchasing and accounting functions. Customer use of Premier Pages had boosted the productivity of Dell salespeople assigned to these accounts by 50 percent. Dell was providing Premier Page service to additional customers annually and adding more features to further improve functionality.

PRODUCT DESIGN SERVICES One of Dell's latest services for large customers was making special-purpose products for such customers as Internet search providers, social networking sites, and big video content sites that might need 10,000 or more units to accommodate its requirements. Such customers did not want to pay for a general-purpose product with components or performance features it did not need. So Dell created a group that had the capability to provide a big user with thousands of units of a product stripped of unnecessary features and equipped with whatever processor, memory, and disk drive suited the customer's needs. Dell personnel would visit with the customer, ascertain the customer's needs and preferences, provide a prototype within three weeks for evaluation and testing, make any additional changes within another two weeks for further testing and evaluation, and then be in volume production by the thousands of units within another three or four weeks—altogether about a nine-week design-to-production/delivery cycle.

VALUE-ADDED SERVICES FOR CUSTOMERS WITH LARGE IT OPERATIONS Dell kept close track of the purchases of its large global customers, country by country and department by department—and customers themselves found this purchase information valuable. Dell's sales and support personnel used their knowledge about a particular customer's needs to help that customer plan PC purchases, to configure the customer's PC networks, and to provide value-added services. For example, for its large customers Dell loaded software and placed ID tags on newly ordered PCs at the factory, thereby eliminating the need for the customer's IT personnel to unpack the PC, deliver it to an employee's desk, hook it up, place asset tags on the PC, and load the needed software—a process that could take several hours and cost $200–$300.[19] While Dell charged an extra $15 or $20 for the software-loading and asset-tagging services, the savings to customers were still considerable—one large customer reported savings of $500,000 annually from this service.[20]

In 2007 and early 2008, Dell spent about $2 billion to make a series of software-related acquisitions that gave it an altogether new value-added capability:

1. Everdream Corporation—Everdream was a leading provider of Software as a Service (SaaS) solutions, with operations in California and North Carolina. This acquisition enabled Dell to extend its capabilities to use the Internet to remotely manage global delivery of software solutions from servers, storage devices, and printers to desktop PCs, laptops, and other end-user devices. Dell management believed that remote-service management of software products would help business customers of all sizes simplify their IT infrastructure—a value-added outcome that Dell was aggressively pursuing. Terms of the acquisition were not disclosed.
2. SilverBack Technologies Inc.—Silverback was a privately owned, Massachusetts-based company that had a delivery platform to remotely manage and monitor SaaS products. Such a platform was essential to Dell's strategy of simplifying customers' IT infrastructures by providing their personnel with desirable software applications on an as-needed basis via the Internet. Terms of the acquisition were not disclosed.
3. MessageOne Inc.—Acquired for $155 million, MessageOne was an industry leader in SaaS-enabled continuous e-mail service, e-mail archiving, and disaster recovery of e-mail messages. The MessageOne acquisition further enhanced Dell's strategy to use SaaS applications and remote software management tools to deliver configure-to-order IT services to commercial customers over the Internet.
4. EqualLogic—This company, acquired for $1.4 billion, was a leading provider of high-performance storage area network (SAN) solutions that made storing and processing data easier and cheaper. EqualLogic's technological capabilities allowed Dell to offer its customers a secure data storage solution that used the customer's existing IT infrastructure, could be installed in minutes, managed itself, and was easily expanded as needsi ncreased.
5. ASAP Software—ASAP, acquired at a cost of $340 million, was a leading software solutions and licensing services provider, with expertise in software licensing and the management of IT assets. The ASAP acquisition expanded Dell's lineup of software offerings from 200 to 2,000.
6. The Networked Storage Company—Networked Storage was a leading IT consulting group that specialized in transitioning customers to proven, simplified, cost-efficient data storage solutions. Dell management saw this acquisition as an important element in its strategy to build the capability to offer Dell customers simple, cost-effective ways to manage their IT infrastructures. Terms of the acquisition were not disclosed.

Dell management saw all six acquisitions as greatly strengthening the company's capabilities to provide an altogether new value-added service to customers with sizable IT operations, all of whom were finding the tasks of managing and maintaining an IT infrastructure to be increasingly complex and costly. Executives at Dell believed that having greater capability than rivals to offer commercial customers simple, cost-effective ways to manage their IT operations would give Dell added competitiveness in marketing its lineup of product offerings to commercial enterprises worldwide. While Dell already was the sales leader in

PCs sold to corporations and businesses in North America and Europe, extending its lead in these regions and growing sales and market share in the remaining parts of the world could make a material contribution not only to growing Dell's overall business but also to overtaking Hewlett-Packard as the global leader in PCs.

ENHANCED SERVICES AND SUPPORT FOR LARGE ENTERPRISES Corporate customers paid Dell fees to provide on-site service and help with migrating to new information technologies. Service revenues had climbed from $1.7 billion in 2002 to about $5.3 billion in fiscal 2008. This portion of Dell's business was split between what Michael Dell called close-to-the-box services and management/professional services. Dell estimated that close-to-the-box support services for Dell products represented about a $50 billion market as of 2005, whereas the market for management/professional services (IT life-cycle services, deployment of new technology, and solutions for greater IT productivity) in 2005 was about $90 billion. The market for IT consulting and services was forecast to be in the $850–$900 billion range in 2011. For the most part, IT consulting services were becoming more standardized, driven primarily by growing hardware and software standardization, reduction in on-site service requirements (partly because of online diagnostic and support tools, growing ease of repair and maintenance, increased customer knowledge, and increased remote management capabilities), and declines in the skills and know-how that were required to perform service tasks on standardized equipment and install new, more standardized systems.

Dell's strategy in enhanced services, like its strategy in hardware products, was to bring down the cost of IT-related services for its large enterprise customers and free customers from "overpriced relationships" with such vendors as IBM, Sun Microsystems, and Hewlett-Packard that typically charged premium prices ($250 per hour) and realized hefty profits for their efforts.[21] According to Michael Dell, customers who bought the services being provided by Dell saved 40 to 50 percent over what they would have paid other providers of IT services.

The caliber of technical support and customer service that Dell provided to its large enterprise customers was highly regarded (despite the problems sometimes experienced by small businesses and individuals). In a 2005 survey of IT executives by *CIO* magazine, Dell was rated number one among leading vendors for providing "impeccable customer service" to large enterprises.

PROVIDING ONLINE SHOPPERS WITH CUSTOMER REVIEWS OF DELL PRODUCTS Users of Dell products were encouraged to provide Dell with a review of their experiences with the products they had purchased. As part of the review process, customers were asked to provide a rating of the product using a 5-point scale that ran from 1 (poor) to 5 (excellent). Shoppers browsing through Dell's product offerings could view the average customer rating score for each product directly on the screen where the product details were displayed and could click on an adjacent link to read the accompanying reviews. In 2008, about 50,000 customer reviews of Dell products were posted and available for inspection.

LISTENING TO CUSTOMERS In addition to using its sales and support mechanisms to stay close to customers, Dell periodically held regional forums that gave senior Dell personnel opportunities to listen to the company's biggest and most influential customers and discuss their emerging needs and expectations. The meeting agenda frequently included a presentation by Michael Dell, plus presentations by Dell's senior technologists on the direction of the latest technological developments and what the flow of technology really meant for customers, presentations on what new and upgraded products Dell was planning to introduce, and breakout sessions on topics of current interest.

In February 2007, Dell began inviting customers to post their ideas for improving its products and services at a section of its Web site called IdeaStorm. As of April 2008, customers had posted more than 8,900 ideas, 45 of which had been implemented. Michael Dell believed that the Internet and the speed with which people worldwide were able to connect to the Internet via a growing number of devices had forever redefined what it means to listen to customers:

> Listening used to mean commissioning a customer survey. Now it means engaging directly with customers and critics and using those relationships to create a smarter business. Tapping into the ideas of our customers is like having an open source R&D lab.[22]

Customer-DrivenR esearch and Development and Standardized Technology

Dell's R&D focus was to track and test new developments in components and software, ascertain which ones would prove most useful and cost-effective for customers, and then design them into Dell products. Management's philosophy was that it was Dell's job on behalf of its customers to sort out all the new technology coming into the marketplace and design products having the features, options, and solutions that were the most relevant for customers. Studies conducted by Dell's R&D personnel indicated that, over time, products incorporating standardized technology delivered about twice the performance per dollar of cost as products based on proprietary technology.

At the University of Buffalo, for example, Dell had installed a 5.6 teraflop cluster of about 2,000 Dell servers containing 4,000 microprocessors that constituted one of the most powerful supercomputers in the world and gave researchers the computing power needed to help decode the human genome. The cluster of servers, which were the same as those Dell sold to many other customers, had been installed in about 60 days at a cost of a few million dollars—far less than the cost of another vendor's supercomputer that used proprietary technology. Energy giant Amerada Hess Corporation (now known as Hess Corporation), attracted by Dell's use of standardized and upgradable parts and components, installed a cluster of several hundred Dell workstations and allocated about $300,000 a year to upgrade and maintain it; the cluster replaced an IBM supercomputer that cost $1.5 million a year to lease and operate.

Dell's R&D unit also studied and implemented ways to control quality and to streamline the assembly process. In 2008, Dell had a portfolio of 1,954 U.S. patents and another 2,196 patent applications were pending. Dell's R&D group included about 4,000 engineers, and its annual budget for research, development, and engineering was in the $430–$500 million range before jumping to more than $600 million in fiscal 2008 (see Exhibit 2).

Other Elements of Dell's Business Strategy

Dell's strategy had three other elements that complemented its core strategy: entry into the white-box segment of the PC industry, advertising, and continuous pursuit of cost reduction initiatives.

DELL'S ENTRY INTO THE WHITE-BOX PC SEGMENT In 2002, Dell announced it would begin making so-called white-box (i.e., unbranded) PCs for resale under the private labels of retailers. PC dealers that supplied white-box PCs to small businesses and price-conscious individuals under the dealer's own brand name accounted for about one-third of total PC sales and about 50 percent of sales to small businesses. According to one industry analyst, "Increasingly, Dell's biggest competitor these days isn't big brand-name companies like IBM or HP; it's white-box vendors." Dell's thinking in entering the white-box PC segment was that it was cheaper to reach many small businesses through the white-box dealers that already served them than by using its own sales force and support groups to sell and service businesses with fewer than 100 employees. Dell believed that its low-cost supply chain and assembly capabilities would allow it to build generic machines cheaper than white-box resellers could buy components and assemble a customized machine. Management forecast that Dell would achieve $380 million in sales of white-box PCs in 2003 and would generate profit margins equal to those on Dell-branded PCs. Some industry analysts were skeptical of Dell's move into white-box PCs because they expected white-box dealers to be reluctant to buy their PCs from a company that had a history of taking their clients. Others believed this was a test effort by Dell to develop the capabilities to take on white-box dealers in Asia and especially in China, where the sellers of generic PCs were particularly strong.

ADVERTISING Michael Dell was a firm believer in the power of advertising and frequently espoused its importance in the company's strategy. He insisted that the company's ads be communicative and forceful, not soft and fuzzy. The company regularly had prominent ads describing its products and prices in such leading computer publications as *PC Magazine* and *PC World*, as well as in *USA Today, The Wall Street Journal*, and other business publications. From time to time, the company ran ads on TV to promote its products to consumers and small businesses. Catalogs of about 25–30 pages describing Dell's latest desktop and laptop PCs, along with its printers and other offerings, were periodically mailed to consumers who had bought Dell products. Other marketing initiatives included printing newspaper inserts and sending newsletters and promotional pieces to customers via the Internet.

CONTINUOUS PURSUIT OF COST-REDUCTION INITIATIVES Michael Dell had long been an ardent advocate of relentless efforts to improve efficiency and keeps costs as low as feasible. But during Kevin Rollins's tenure as CEO, Dell's cost edge over rivals had narrowed, and the company's profit margins had slipped as well (partly because fierce price competition was driving down the prices of many products that Dell sold faster than Dell was able to lower its costs per unit)—Exhibit 7 shows the downward trend in the average revenue Dell received from each unit sold. When he reassumed his role as CEO in 2007, Michael Dell announced that tighter controls over operating expenses would be implemented immediately and that management would begin an in-depth exploration of ways for improving Dell's cost-competitiveness, organizing operations more efficiently, and boosting profitability and cash flows. In May 2007, Dell announced an initiative to reduce the global workforce headcount by 10 percent, or 8,800 people. By March 2008, a net of 3,200 jobs had been eliminated. However, the company had actually hired 2,100 more people to staff frontline operations and customer-facing activities; the net reduction of 3,200 people was achieved by cutting 5,300 personnel engaged in performing what Dell called non-frontline activities. The result was to increase the number of Dell employees engaged in frontline and customer-facing activities from 54 percent to 57 percent.

In March 2008, Dell executives announced that over the next three years the company would seek to achieve annualized savings of $3 billion via productivity improvements and cost-reduction efforts across all the company's value chain—design, supply chain logistics, materials, manufacturing, and other operating activities. Management reaffirmed its commitment to reducing the global employee headcount by 8,800 and achieving the related labor-cost savings. At the same time, Dell also put programs in place to reignite the company's revenue growth in five focus areas: global consumer products, sales to large enterprise customers, laptop computers, sales to small and medium enterprises, and sales in emerging countries.

The Information Technology Marketplace in 2008

Analysts expected the worldwide IT industry to grow from $1.2 trillion in 2007 to $1.5 trillion in 2010, a compound growth rate of about 7.7 percent. Of that projected 2010 total, about $560 billion was expected to be for hardware

(PCs, servers, storage devices, networking equipment, and printers and peripherals); $327 billion for software; and $613 billion for services. From 1980 to 2000, IT spending had grown at an average annual rate of 12 percent; thereafter, it had flattened—to a 1 percent decline in 2001, a 2.3 percent decline in 2002, a single-digit increase in 2003—then rose more briskly at rates in the 5–10 percent range in 2004, 2005, 2006 and 2007. The slowdown in IT spending in 2001–2007 compared to earlier years reflected a combination of factors: sluggish economic growth in many countries in 2001–2003; overinvestment in IT in the 1995–1999 period; declining unit prices for many IT products (especially PCs and servers); and a growing preference for lower-priced, standard-component hardware that was good enough to perform a variety of functions using off-the-shelf Windows or Linux operating systems (as opposed to relying on proprietary hardware and customized Unix software). The selling points that appealed most to IT customers were standardization, flexibility, modularity, simplicity, economy of use, and value.

There were several driving forces contributing to increased global spending for information technology products and services starting in 2004.[23] One was the explosion of digital information and content. According to Forrester Research, the world's data doubled approximately every three years, a phenomenon that was expected to produce more than a sixfold increase in data between 2003 and 2010. A second force was the rapid expansion of search engine activity, e-mail, text messages, social networking Web sites like My Space and Facebook, blogs, and online video and images; these fed the worldwide demand for digital devices to create, store, share, and print the mushrooming volume of digital information and content. The third force was the rapidly growing demand for information technology products and services in emerging markets around the world—like Brazil, Russia, China, India, and several other countries in Southeast Asia and Eastern Europe—where over half of the world's population resided. At the same time, several other complicating factors were at work. Much of the growing volume of content lacked authentication and proper security, plus the content was increasingly global and mobile. And consumer expectations were changing—people wanted instantaneous access to content regardless of what kind of device they were using or where they happened to be, and their tolerance for complexity was low. All of these aspects of the global IT marketplace created huge opportunities for IT providers and huge challenges for IT users.

Exhibit 8 shows actual and projected PC sales for 1980–2012 as compiled by industry researcher International Data Corporation (IDC). According to Gartner Research, the billionth PC was shipped sometime in July 2002; of the billion PCs sold, an estimated 550 million were still in use. Forrester Research estimated that the numbers of PCs in use worldwide would exceed 1 billion by the end of 2008 (up from 575 million in 2004) and would approach 1.3 billion by 2011 and 2.0 billion by 2016. With a world population of more than 6 billion, most industry participants believed there was ample opportunity for further growth in the PC market. Growth potential for PCs was particularly strong in Russia, China, India, several other Asian countries, and portions of Latin America (especially Brazil and Mexico). At the same time, forecasters expected full global buildout of the Internet to continue, which would require the installation of millions of servers.

How Dell's Strategy Put Competitive Pressure on Rivals

When the personal computer industry first began to take shape in the early 1980s, the founding companies manufactured many of the components themselves—disk drives, memory chips, graphics chips, microprocessors, motherboards, and software. Subscribing to a philosophy that mandated in-house development of key components, they built expertise in a variety of PC-related technologies and created

Exhibit 8

Worldwide Shipments of PCs, Actual and Forecast, 1980–2012 (in millions)

YEAR	PCs SHIPPED
1980	1
1985	11
1990	24
1995	58
2000	139
2001	133
2002	136
2003	153
2004	177
2005	208
2006	235
2007	269
2008*	302
2009*	335
2010*	368
2011*	398
2012*	426

*Forecast.
Source: International Data Corporation.

organizational units to produce components as well as handle final assembly. While certain noncritical items were typically outsourced, if a computer maker was not at least partially vertically integrated and did not produce some components for its PCs, then it was not taken seriously as a manufacturer. But as the industry grew, technology advanced quickly in so many directions on so many parts and components that the early personal computer manufacturers could not keep pace as experts on all fronts. There were too many technologies and manufacturing intricacies to master for a vertically integrated manufacturer to keep its products on the cutting edge.

As a consequence, companies emerged that specialized in making particular components. Specialists could marshal enough R&D capability and resources to either lead the technological developments in their area of specialization or else quickly match the advances made by their competitors. Moreover, specialist firms could mass-produce the component and supply it to several computer manufacturers far cheaper than any one manufacturer could fund the needed component R&D and then make only whatever smaller volume of components it needed for assembling its own brand of PCs. Thus, in the early 1990s, such computer makers as Compaq Computer, IBM, Hewlett-Packard, Sony, Toshiba, and Fujitsu-Siemens began to abandon vertical integration in favor of a strategy of outsourcing most components from specialists and concentrating on efficient assembly and marketing their brand of computers. They adopted the build-to-stock value chain model shown in the top section of Exhibit 4. It featured arm's-length transactions between specialist suppliers, manufacturer/assemblers, distributors and retailers, and end users. However, a few others, most notably Dell and Gateway, employed a shorter value chain model, selling directly to customers and eliminating the time and costs associated with distributing through independent resellers. Building to order avoided (1) having to keep many differently equipped models on retailers' shelves to fill buyer requests for one or another configuration of options and components, and (2) having to clear out slow-selling models at a discount before introducing new generations of PCs—for instance, Hewlett-Packard's retail dealers had an average of 43 days of HP products in stock as of October 2004. Direct sales eliminated retailer costs and markups; retail dealer margins were typically in the range of 4–10 percent.

Because of Dell's success in using its business model and strategy to become the low-cost leader, most other PC makers had tried to emulate various aspects of Dell's strategy, but with only limited success. Nearly all vendors were trying to cut days of inventory out of their supply chains and reduce their costs of goods sold and operating expenses to levels that would make them more cost-competitive with Dell. In an effort to cut their assembly costs, several others (including HP) had begun outsourcing assembly to contract manufacturers and refocusing their internal efforts on product design and marketing. Virtually all PC vendors were trying to minimize the amount of finished goods in dealer/distributor inventories and shorten the time it took to replenish dealer stocks. Collaboration with contract manufacturers was increasing to develop the capabilities to build and deliver PCs equipped to customer specifications within 7 to 14 days, but these efforts were hampered by the use of Asia-based contract manufacturers—delivering built-to-order PCs to North American and European customers within a two-week time frame required the use of costly air freight from assembly plants in Asia.

While most PC vendors would have liked to adopt Dell's sell-direct strategy for at least some of their sales, they confronted big channel conflict problems: If they started to push direct sales hard, they would almost certainly alienate the independent dealers on whom they depended for the bulk of their sales and service to customers. Dealers saw sell-direct efforts on the part of a manufacturer whose brand they represented as a move to cannibalize their business and to compete against them. However, Dell's success in gaining large enterprise customers with its direct sales force had forced growing numbers of PC vendors to supplement the efforts of their independent dealers with direct sales and service efforts of their own. During 2003–2007, several of Dell's rivals were selling 15 to 25 percent of their products direct.

Hewlett-Packard: Dell's Chief Rival in PCs and x86 Servers

In one of the most contentious and controversial acquisitions in U.S. history, Hewlett-Packard shareholders in early 2002 voted by a narrow margin to approve the company's acquisition of Compaq Computer, the world's second largest full-service global computing company (behind IBM), with 2001 revenues of $33.6 billion and a net loss of $785 million. Compaq had passed IBM to become the world leader in PCs in 1995 and remained in first place until it was overtaken by Dell in late 1999. Compaq had acquired Tandem Computer in 1997 and Digital Equipment Corporation in 1998 to give it capabilities, products, and service offerings that allowed it to compete in every sector of the computer industry—PCs, servers, workstations, mainframes, peripherals, and such services as business and e-commerce solutions, hardware and software support, systems integration, and technology consulting.[24] In 2000, Compaq spent $370 million to acquire certain assets of Inacom Corporation that management believed would help Compaq reduce inventories, speed cycle time, and enhance its capabilities to do business with customers via the Internet. Nonetheless, at the time of its acquisition by HP, Compaq was struggling to compete successfully in all of the many product and service arenas where it operated.

Carly Fiorina, who became HP's CEO in 1999, explained why the acquisition of Compaq was strategically sound:[25]

> With Compaq, we become No. 1 in Windows, No. 1 in Linux and No. 1 in Unix . . . With Compaq, we become the No. 1 player in storage, and the leader in the fastest growing segment of the storage market—storage area networks. With Compaq, we double our service and support capacity in the area of mission-critical infrastructure design, outsourcing and support. . . . Let's talk about PCs. . . . Compaq has been able to improve their turns in that business from 23 turns of inventory per year to 62—100 percent improvement year over year—and they are coming close to doing as well as Dell does. They've reduced operating expenses by $130 million, improved gross margins by three points, reduced channel inventory by more than $800 million. They ship about 70 percent of their commercial volume through their direct channel, comparable to Dell. We will combine our successful retail PC business model with their commercial business model and achieve much more together than we could alone. With Compaq, we will double the size of our sales force to 15,000 strong. We will build our R&D budget to more than $4 billion a year, and add important capabilities to HP Labs. We will become the No. 1 player in a whole host of countries around the world—HP operates in more than 160 countries, with well over 60 percent of our revenues coming from outside the U.S. The new HP will be the No. 1 player in the consumer and small- and medium-business segments. . . . We have estimated

> cost synergies of $2.5 billion by 2004. . . . It is a rare opportunity when a technology company can advance its market position substantially and reduce its cost structure substantially at the same time. And this is possible because Compaq and HP are in the same businesses, pursuing the same strategies, in the same markets, with complementaryc apabilities.

However, going into 2005 the jury was still out on whether HP's acquisition of Compaq was the success that Carly Fiorina had claimed it would be. The company's only real bright spot was its $24 billion crown jewel printer business, which still reigned as the unchallenged world leader. But the rest of HP's businesses (PCs, servers, storage devices, digital cameras, calculators, and IT services) were underachievers. Its PC and server businesses were struggling, losing money in most quarters and barely breaking even in others—and HP was definitely losing ground to Dell in PCs and low-priced servers. In servers, HP was being squeezed on the low end by Dell's low prices and on the high end by strong competition from IBM. According to most observers, IBM overshadowed HP in corporate computing—high-end servers and IT services. HP had been able to grow revenues in data storage and technical support services, but profit margins and total operating profits were declining. While HP had successfully cut annual operating costs by $3.5 billion—beating the $2.5 billion target set at the time of the Compaq acquisition, the company had missed its earnings forecasts in 7 of the past 20 quarters.

With HP's stock price stuck in the $18–$23 price range, impatient investors in 2004 began clamoring for the company to break itself up and create two separate companies, one for its printer business and one for all the rest of the businesses. While HP's board of directors had looked at breaking the company into smaller pieces, Carly Fiorina was steadfastly opposed, arguing that HP's broad product/business lineup paid off in the form of added sales and lower costs. But in February 2005, shortly after HP released disappointing financials for 2004 (the company's earnings per share total of $1.16 in 2004 was substantially below the earnings per share total of $1.80 reported in 2000), Carly Fiorina resigned her post as HP's CEO amid mounting differences between herself and members of HP's board of directors about what actions were needed to revive HP's earnings.

Mark Hurd, president and CEO of NCR (formerly National Cash Resister Systems), was brought in to replace Fiorina, effective April 1, 2005; Hurd had been at NCR for 25 years in a variety of management positions and was regarded as a no-nonsense executive who underpromised and overdelivered on results.[26] Hurd immediately sought to bolster HP's competitiveness and financial performance by bringing in new managers and attacking bloated costs. In his first seven months as CEO, the results were encouraging. HP posted revenues of $86.7 billion and net profits of $2.4 billion for the fiscal year ending October 31, 2005. HP had the number one ranking worldwide for server shipments (a position it had held for 14 consecutive quarters) and disk storage systems, plus it was the world leader in server revenues for Unix, Windows, and Linux systems. During the first seven months that Hurd was HP's CEO, the company's stock price rose about 25 percent.

With Hurd at the helm, Hewlett-Packard continued to gain traction in the marketplace in the next two fiscal years. For example, HP's sales of laptop computers increased 47 percent in fiscal 2007 and its PC business in China nearly doubled, making China HP's third biggest market for PCs. The company posted revenues of $91.7 billion in fiscal 2006 and $104.3 billion in fiscal 2007. Earnings climbed from $2.4 billion in 2005 to $6.2 billion in 2006 (equal to a diluted earnings per share of $2.18) and to $7.3 billion in 2007 (equal to a diluted earning per share of $2.68). By late fall 2007, HP's stock price was more than double what it had been during Carly Fiorina's last days as CEO. The company's 2007 share of the estimated $1.2 trillion global IT market was almost 9 percent. It was the global leader in both PCs and x86 servers running on Windows and Linux operating systems. About 67 percent of HP's sales were outside the United States. In May 2008, HP announced that it was expecting fiscal 2008 revenues of about $114 billion and a diluted earnings per share in the range of $3.30 to $3.34. Exhibit 9 shows the performance of Hewlett-Packard's four major business groups for fiscal years 2001–2007.

HP's strategy in PCs and servers differed from Dell's in two important respects:

1. Although HP had a direct sales force that sold direct to large enterprises and select other customers, a very sizable share of HP's sales of PCs were made through distributors, retailers, and other channels. These included:
   - Retailers that sold HP products to the public through their own physical or Internets tores.
   - Resellers that sold HP products and services, frequently with their own value-added products or services, to targeted customer groups.
   - Distribution partners that supplied HP products to smaller resellers with which HP had no direct relationships.
   - Independent distributors that sold HP products into geographic areas or customer segments in which HP had little or no presence.
   - Independent software vendors that often assisted HP in selling HP computers, servers, and other products/services to their software clients.

Exhibit 9

Performance of Hewlett-Packard's Four Major Business Groups, Fiscal Years 2001–2007 (in millions)

FISCAL YEARS ENDING OCTOBER 31	PRINTING AND IMAGING	PERSONAL COMPUTING SYSTEMS	ENTERPRISE SYSTEMS AND SOFTWARE	HP SERVICES
2007				
Net revenue	$28,465	$36,409	$21,094	$16,646
Operating income	4,315	1,939	2,327	1,829
2006				
Net revenue	$26,786	$29,169	$18,609	$15,617
Operating income	3,978	1,152	1,531	1,507
2005				
Net revenue	$25,155	$26,741	$17,878	$15,536
Operating income	3,413	657	751	1,151
2004				
Net revenue	$24,199	$24,622	$16,074	$13,778
Operating income	3,847	210	28	1,263
2003				
Net revenue	$22,569	$21,210	$15,367	$12,357
Operating income (loss)	3,596	22	(48)	1,362
2002*				
Net revenue	$20,358	$21,895	$11,105	$12,326
Operating income (loss)	3,365	(372)	(656)	1,369
2001*				
Net revenue	$19,602	$26,710	$20,205	$12,802
Operating income (loss)	2,103	(728)	(579)	1,617

*Results for 2001 and 2002 represent the combined results of both HP and Compaq Computer.
Source: Company 10-K reports 2003, 2004, and 2007.

- Systems integrators that helped large enterprises design and implement custom IT solutions and often recommended that these enterprises purchase HP products when such products were needed to put a customized IT solution in place.

Much of HP's global market clout in PCs and servers came from having the world's biggest and most diverse network of distribution partners. The percentage of PCs and servers sold by its direct sales force and by its various channel partners varied substantially by geographic region and country, partly because customer buying patterns and different regional market conditions made it useful for HP to tailor its sales, marketing, and distribution accordingly.

2. While in-house personnel designed the company's PCs and x86 servers, the vast majority were assembled by contract manufacturers located in various parts of the world. Big-volume orders from large enterprise customers were assembled to each customer's particular specifications. The remaining units were assembled and shipped to HP's retail and distribution partners; these were configured in a variety of ways (different microprocessor speeds, hard drive sizes, display sizes, memory size, and so on) that HP and its resellers thought would be attractive to customers and then assembled in large productions runs to maximize manufacturing efficiencies.

During 2005–2007, after replacing a number of HP's senior executives, Mark Hurd engineered several strategic moves to strengthen HP's competitiveness and ability to deliver better financial performance to shareholders:

- Top executives charged each HP business with identifying and implementing opportunities to boost efficiency and lower costs per unit. Every aspect of the company's supply chain and internal cost structure was scrutinized for ways to become more efficient and reduce costs. The costs of each value chain component—from real estate to procurement to IT to marketing—were examined so that managers could know costs by business group, region, country, site, product, and employee; these levels of cost analysis were then used to scrutinize how each expense supported HP's strategy and whether there were opportunities for cost savings. Corporate overheads were trimmed, negotiations with suppliers were conducted to be sure that HP was getting the best terms and best prices on its purchases, steps were taken to trim HP's workforce by about 15,000 people worldwide, the organizational structure was streamlined resulting in three layers of management being removed, and the company's very complicated IT operations were simplified and the expenses reduced—the objective was to engineer HP's IT architecture and operations to be the world's best showcase for the company's technology. In 2008, HP began trimming the number of sites worldwide at which it conducted activities by 25 percent. The resulting improvements in operating expenses paved the way for HP to price its products more competitively against those of Dell and other rivals.
- Company personnel began working more closely with large enterprise customers to find ways to simplify their experience with informationt echnology.
- A number of new products and services werei ntroduced.
- HP spent close to $7 billion to acquire more than a dozen software, technology, and service companies that management believed would add significant capabilities and technology to HP's portfolio and help fuel revenue growth.
- The company prepared to capitalize on three big growth opportunities that top management saw emerging over the next

four or five years: (1) next-generation data center architecture; (2) growing consumer interest in always-ready, always-on mobile computing; and (3) digital printing. Mark Hurd believed that HP had important strengths in all three of these high-growth market arenas but needed to be more adept in getting new products into the marketplace. He directed company personnel to develop a better "go-to-market" model and to arm the sales force with the tools needed to "get quotes and proposals in front of customers as fast as anybody on the planet." HP added 1,000 people to its sales force in 2007 to expand its coverage of key accounts and geographic markets; an additional 1,000 salespeople were added through acquisitions.

Soon after becoming CEO in 2005, Mark Hurd concluded that HP needed to beef up its IT services business in order to go head-to-head against IBM, the unquestioned worldwide leader in IT services; IBM had 2007 revenues of about $54 billion and an estimated 7.2 percent global share of a $748 billion market. Hurd took a major step in that direction in May 2008, making his first really big strategic move as HP's CEO by cutting a deal to acquire Electronic Data Systems (EDS) for a cash price of $13.25 billion. According to Gartner (one of the world's leading technology research firms), EDS had IT service revenues of $22.1 billion in 2007, equal to a global share of 3.0 percent—ahead of HP with revenues of $17.3 billion and a 2.3 percent share (see Exhibit 10 for the sales and market shares of the world's top six IT service providers). While a combined HP/EDS would have IT service revenues of more than $49 billion and market share of 5.3 percent—sufficient for a strong second place in the global market—industry observers were not enamored with the ability of HP/EDS to compete with IBM for high-end, high-profit buyers of IT services. IBM's profit margin in IT services was almost double EDS's 6 percent profit margin, partly because IBM catered to the needs of high-end customers and partly because IBM had about 74,000 employees in India, where wages for IT professionals were considerably lower—only 27,000 of EDS's 140,000 employees were in India.

EDS, founded in 1962, was best known for its capabilities in running clients' mainframe systems, operating help desks to support personal computer users, developing and running business software for its clients, and handling such automated IT processes as billing and payments for clients.[27] In contrast, HP's IT service business revolved around managing infrastructure—such as back-office server systems—for its large enterprises. There was relatively little overlap between the customer bases of the two companies. HP executives believed there was plenty of opportunity to cut costs at EDS and that there were clear revenue-boosting opportunities, such as expanding sales of managed printing services. Even so, HP's shareholders were unenthusiastic about the EDS acquisition—HP's stock price fell more than $10 per share in the two days following news of the acquisition but recovered $2.50 of the drop within a week.

Exhibit 10

Estimated Sales and Market Shares of the World's Six Leading Providers of Information Technology Services, 2007

COMPANY	2007 REVENUES (IN BILLIONS)	MARKET SHARE
IBM	$ 54.1	7.2%
Electronic Data Systems (EDS)	22.1	3.0
Accenture	20.6	2.8
Fujitsu	18.6	2.5
Hewlett-Packard	17.3*	2.3
Computer Sciences Corp. (CSC)	16.3	2.2
All others	599.0	80.0
Totals	$748.0	100.0%

*Gartner's $17.3 billion estimate of for HP's 2007 revenues in IT services exceeds the $16.6 billion reported by HP in its 2007 10-K report and shown in Exhibit 9.

Source: Gartner, as reported in Justin Scheck and Ben Worthen, "Hewlett-Packard Takes Aim at IBM," *The Wall Street Journal,* May 14, 2008, p. B1.

Dell'sF utureP rospects

In a February 2003 article in *Business 2.0,* Michael Dell said, "The best way to describe us now is as a broad computer systems and services company. We have a pretty simple system. The most important thing is to satisfy our customers. The second most important thing is to be profitable. If we don't do the first one well, the second one won't happen."[28] For the most part, Michael Dell was not particularly concerned about the efforts of competitors to copy many aspects of Dell's build-to-order, sell-direct strategy. He explained why on at least two occasions:

> The competition started copying us seven years ago. That's when we were a $1 billion business. . . . And they haven't made much progress to be honest with you. The learning curve for them is difficult. It's like going from baseball to soccer.[29]
>
> I think a lot of people have analyzed our business model; a lot of people have written about it and tried to understand it. This is an 18½-year process. . . .It comes from many, many cycles of learning. . . . It's very, very different than designing products to be built to stock. . . . Our whole company is oriented around a very different way of operating. . . .I don't, for any second, believe that they are not trying to catch up. But it is also safe to assume that Dell is not staying in the same place.[30]

On other occasions, Michael Dell spoke about the size of the company's future opportunities:

> When technologies begin to standardize or commoditize, the game starts to change. Markets open up to be volume markets and this is very much where Dell has made its mark—first in the PC market in desktops and notebooks and then in the server market and the storage market and services and data networking. We continue to expand the array of products that we sell, the array of services and, of course, expand on a geographic basis. The way we think about it is that there are all of these various technologies out there. . . . What we have been able to do is build a business system that takes those technological ingredients, translates them into products and services, and gets them to the customer more efficiently than any company around.[31] There are enormous opportunities for us to grow across multiple dimensions in terms of products, with servers, storage, printing and services representing a huge realm of expansion for us. There's geographic expansion and market share expansion back in the core business. The primary focus for us is picking those opportunities, seizing on them, and making sure we have the talent and the leadership growing inside the company to support all that growth. And there's also a network effect here. As we grow our product lines and enter new markets, we see a faster ability to gain share in new markets versus ones we've previously entered.[32]
>
> A great portion of our growth will come from key markets outside the U.S. We have about 10 percent market share outside the United States, so there's definitely room to grow. We'll grow in the enterprise with servers, storage, and services. Our growth will come from new areas like printing. And, quite frankly, those are really enough. There are other things that I could mention, other things we do, but those opportunities I mentioned can drive us to $80 billion and beyond.[33]

That Dell had ample growth opportunities was indisputable—in 2007, it only had a minuscule 2 percent share of the $1.2 trillion global market for IT products and services. Exhibit 11 shows Dell's principal competitors in each of the industry's major product categories and its estimated 2007 market shares in each category.

In 2008, despite near-term prospects of sluggish economic growth in the United States and perhaps elsewhere, Michael Dell remained enthusiastic about the unrivaled opportunity for the company's business given that the number of people online globally (via PCs, cell phones, and other devices with Internet connectivity) was expected to increase from just over 1 billion in 2008 to over 2 billion by 2011:

> The world is witnessing the most exciting and promising period for technology ever seen. We call it the "Connected Era." The second billion people coming online, many from the world's fast growing and emerging economies, expect a different technology experience to the first. The Internet has unleashed billions of new conversations and made it possible for people to connect in

Exhibit 11

Dell's Principal Competitors and Dell's Estimated Market Shares by Product Category, 2007

PRODUCT CATEGORY	DELL'S PRINCIPAL COMPETITORS	ESTIMATED SIZE OF WORLDWIDE MARKET, 2007	DELL'S ESTIMATED WORLDWIDE SHARE, 2007
PCs	Hewlett-Packard (maker of both Compaq and HP brands), Lenovo, Apple, Acer, Toshiba, Sony, Fujitsu-Siemens (in Europe and Japan)	$375 billion	~15%
Servers	Hewlett-Packard, IBM, Sun Microsystems, Fujitsu	$60 billion	~11%
Data storage devices	Hewlett-Packard, IBM, EMC, Hitachi	$48 billion	~5%
Networking switches and related equipment	Cisco Systems, Broadcom, Enterasys, Nortel, 3Com, Airespace, Proxim	~$65 billion	~2%
Printers and printer cartridges	Hewlett-Packard, Lexmark, Canon, Epson	~$50 billion	~5%
Services	Accenture, IBM, Hewlett-Packard, Fujitsu, EDS, many others	$748 billion	<1%

Source: Compiled by the case authors from a variety of sources, including International Data Corporation, www.dell.com, and *The Wall Street Journal,* May 14, 2008, p. B1.

Exhibit 12

Worldwide Unit Sales and Market Shares of Top Five PC Manufacturers, First Quarter 2008 versus Fourth Quarter 2007

RANK	COMPANY	Q1, 2008 SHIPMENTS	MARKET SHARE	Q4, 2007 SHIPMENTS	MARKET SHARE	PERCENTAGE GROWTH IN SHIPMENTS
1	Hewlett-Packard	13,251,000	19.1%	11,291,000	18.6%	17.4%
2	Dell	10,913,000	15.7	8,971,000	14.8	21.6
3	Acer*	6,914,000	9.9	4,164,000	6.9	66.0
4	Lenovo	4,814,000	6.9	3,980,000	6.6	21.0
5	Toshiba	3,069,000	4.4	2,544,000	4.2	20.6
	All Others	30,537,000	43.9	29,674,000	48.9	2.9
	Total	69,498,000	100.0%	60,624,000	100.0%	14.6%

*Figures for Acer include shipments of Gateway, which was acquired by Acer in 2007.
Source: International Data Corporation, as per posting at www.dell.com (accessed May 12, 2008).

> new ways. The emergence of this connected era is arguably the most influential single trend remodeling the world today.[34]

In May 2008, the latest sales and market share data indicated that Dell might be closing the gap on Hewlett-Packard and on the verge of mounting another run at being the global leader in PC sales. Exhibit 12 shows the sales and market shares of the world's top five PC vendors in the first quarter of 2008 as compared to the fourth quarter of 2007. Moreover, Dell's senior executives believed that their aggressive moves to reduce costs would help restore profit margins, given that there seemed to be some modest relief from having to contend with eroding average revenues per unit sold (see Exhibit7).

However, by late Fall 2008, Dell's prospects for overtaking HP were looking more bleak. Global recessionary forces had caused a significant slowdown in global IT spending during 2008 and even larger cutbacks were being forecast for at least the first half of 2009 in light of the global financial crisis that emerged in Fall 2008. Still, HP reported a 5 percent increase in revenues for its 2008 fourth quarter ending October 31 (excluding the effect of its recent acquisition of EDS) versus the year earlier 2007 fourth quarter and a 2008 fourth quarter earnings increase of 4 percent; moreover HP was forecasting that fiscal 2009 revenues would be in the $127.5 to $130 billion range, up from $118.4 billion in 2008. Dell's sales revenues in the third quarter of 2008 were 3 percent below those in the 2007 third quarter on unit-shipment growth of 3 percent; Dell's third quarter 2008 net profits were down 5 percent.

The Wall Street Journal reported in September 2008 that Dell was trying to sell its worldwide network of computer factories in an effort to reduce production costs; the apparent plan was to enter into agreements with contract manufacturers to produce its PCs. While Dell had for many years been the industry leader in lean manufacturing approaches and cost-efficient build-to-order production methods and was still the low-cost leader in producing desktop PCs, it had fallen behind contract manufacturers in producing notebook PCs cost efficiently—and there was a pronounced shift among individual consumers to purchase laptop PCs instead of desktops. Laptop PCs were more complex and labor-intensive to assemble than were desktops. To help contain the assembly costs of laptops, Dell had already begun having Asian contract manufacturers partially assemble its laptops; these partly assembled laptop units were then shipped to Dell's own plants where assembly was completed. Because each laptop was produced at two factories, Dell referred to its assembly of laptops as a "two-two" system. But the two-touch system was more costly than simply having a contract manufacturer in Asia perform the entire assembly: hence, Dell's interest in abandoning in-house production altogether and shifting to 100 percent outsourcing.

As of late November 2008, Dell had found no buyers for its plants. But the company had nonetheless begun outsourcing the full assembly of some laptop models to contract manufacturers (such as Taiwan's Foxconn Group) to eliminate the extra costs of the two-touch system, and it had made significant progress in cutting operating expenses elsewhere—operating expenses were 12.1 percent of revenues in the 2008 third quarter versus 12.8 percent in the 2007 third quarter. There were some other positives. In the 2008 third quarter, Dell's Global Consumer business posted a 10 percent revenue gain on a 32 percent increase in unit shipments—Dell's revenue growth was double the industry average and the profitability of this business was the highest in 13 quarters. Dell consumer products won 41 awards in the 2008 third quarter—the Inspiron Mini 9 notebook was selected as one of *Time Magazine*'s "Best Inventions of 2008" and as one of CNET's "10 Most Cutting Edge Products of 2008."

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Apple Inc. in 2009

Lou Marino
The University of Alabama

John Hattaway
The University of Alabama

Katy Beth Jackson
The University of Alabama

Heading into the fourth quarter of 2009, management at Apple had much to be excited about. Steve Jobs had returned to lead the company as CEO after receiving a liver transplant earlier in the year, the company had set revenue and earnings records during its most recent quarter, the new iPhone 3GS had sold more than 1 million units within three days of its June 19th launch, and consumers had downloaded more than 1.5 billion iPhone applications by the first anniversary of The App Store launch. However, Apple also faced some significant challenges as it entered the final quarter of 2009. There was some concern that Steve Jobs would not be as effective at the helm of the company as in the past since he would be working only part-time as he further recovered from his surgery. In addition, the role of former acting-CEO and current chief operating officer Tim Cook was not readily apparent as Jobs returned on a part-time basis.

Analysts were also concerned that Apple might struggle to sustain its growth in the smart phone market as Nokia, Research in Motion (the maker of Blackberry smart phones), HTC, LG, and Samsung moved to copy many of the iPhone's features. The iPhone was critical to Apple's continuing growth in revenues and net earnings since the company was the world's third largest seller of smart phones, with a market share of 12.9 percent at year-end 2008. Smart phones, which were multifeature mobile phones capable of sending and receiving e-mails, browsing the Internet, viewing photos and videos, and listening to music, were the fastest growing type of mobile phone and sold at the mobile phone industry's highest price points.

An additional concern centered on what effect the economic recession in the United States and other developed countries would have on Apple's revenues and profits. Economic data released by the U.S. Department of Commerce in July 2009 indicated that the recession of 2008 and 2009, as measured by declining gross domestic product (GDP), was the longest and most severe economic downturn since the Great Depression. The effect of the recession on the consumer technology sector had been considerable with overall consumer technology revenues declining by 4 percent in 2008 and worldwide PC shipments falling by 5 percent during the first six months of 2009. The recession likely contributed to the 7 percent year-over-year decline in Apple's third quarter 2009 iPod sales and its lackluster 4 percent year-over-year growth in third quarter 2009 computer sales. It was unknown what effect the flagging economy would have on Apple TV movie and TV programming rentals or music downloads from Apple's iTunes Store. Although Apple's senior management might be tempted to celebrate the company's recent successes, the convergence of such serious challenges facing the company called for an evaluation of its strategic situation and its approach to sustaining advantage in the consumer technology sector.

Historyo f AppleI nc.

Steven Wozniak and Steven Jobs founded Apple Computer in 1976 when they began selling a crudely designed personal computer called the Apple I to Silicon Valley computer enthusiasts. Two years later the partners introduced the first mass-produced personal computer, the Apple II. The Apple II boasted the first color display and eventually sold more than 10,000 units. While the Apple II was relatively successful, the next revision of the product line, the Macintosh (Mac), would dramatically change personal computing through its user-friendly graphical user interface (GUI) that allowed users to interact with screen images rather than merely type text commands.

The Macintosh that was introduced in 1984 was hailed as a breakthrough in personal computing, but did not have the speed, power, or software availability to compete with the PC that IBM had introduced in 1981. One of the reasons the Macintosh lacked the necessary software was that Apple put very strict restrictions on the Apple Certified Developer Program, which made it difficult for software developers to obtain Macs at a discount and receive informational materials about the operating system.

With the Mac faring poorly in the market, founder Steve Jobs became highly critical of the company's president and CEO, John Sculley, who had been hired by the board in 1983. Finally, in 1985, as Sculley was preparing to visit China, Jobs devised a "boardroom coup" to replace him. Sculley found out about the plan and canceled his trip. After Apple's board voted unanimously to keep Sculley in his position, Jobs, who was retained as chairman of the company but stripped of all decision-making authority, soon resigned. During the remainder of 1985, Apple continued to encounter problems and laid off one-fifth of its employees while posting its first ever quarterly loss. In addition, Sculley entered into a legal battle with Microsoft's Bill Gates over the introduction of Windows 1.0, which used similar technology to the Mac's GUI. Gates eventually signed a document that in effect ensured that Microsoft would not use Mac technology in Windows 1.0 but claimed no such promises for any later versions of Windows. Essentially, Apple had lost the exclusive right to use its own GUI.

Despite these setbacks, Apple kept bringing innovative products to the market, while closely guarding the secrets behind its technology. In 1987, Apple released a revamped Macintosh computer that proved to be a considerable success. This computer was easy to use, making it a favorite at schools and in homes. In addition, the second Macintosh had excellent graphics capabilities. However, by 1990, PCs with Microsoft software had flooded the market and Windows technology was far more prevalent than Mac technology because Microsoft had licensed its software for use on computers built by many different companies.

In 1991, Apple released its first-generation notebook computer, the PowerBook, and, in 1993, Apple's board of directors opted to remove Sculley from the position of CEO. The board chose to place the chief operating officer, Michael Spindler, in the vacated spot. Although Spindler was not a personable, accessible leader, he did oversee Apple's development of several important products. First, in 1994, Apple released the PowerMac family of PCs, the first Macs to incorporate the PowerPC chip, a very fast processor co-developed with Motorola and IBM. Spindler also made a somewhat half-hearted attempt to license the Macintosh operating system (Mac OS) to other companies. However, very few companies ever chose to license the Mac OS because many felt the licensing agreements were far too restrictive.

By 1995, Apple had bigger problems, including $1 billion in back orders and insufficient parts to build those machines. And worse, in the late summer of 1995, Microsoft released Windows 95, which was well suited to compete with the strengths of the Mac OS. During the winter of 1995–96, Apple made some misguided judgments concerning its product line and as a result posted a loss for that quarter. In January 1996, Apple asked Spindler to resign and chose Gil Amelio, former president of National Semiconductor, to take his place.

During his first 100 days in office, Amelio announced many sweeping changes for the company. He split Apple into seven distinct divisions, each responsible for its own profit or loss, and he tried to better inform the developers and consumers of Apple's products and projects. Although Apple announced a staggering first-quarter loss of $740 million in 1996, the company brought down its losses to $33 million by quarter two, an achievement that financial experts had not imagined Apple could accomplish. And in the third quarter, Apple again beat the best estimates, reporting a $30 million profit. At the end of 1996, the company astonished the industry when it announced that it planned to acquire NeXT, the company Steve Jobs had founded upon his resignation from Apple in 1985; Jobs was to be rehired by Apple as part of the acquisition. The acquisition was chosen in order to control NeXTstep, the basis Apple planned to use for its next-generation operating system, Rhapsody. During the summer of 1997, after announcing another multimillion-dollar quarterly loss, Apple determined that Gil Amelio had made many significant improvements in Apple's operations but had done all he could. No permanent replacement was announced, but Fred Anderson, chief financial officer, was placed in charge of daily operations; Jobs was also given an expanded role in the company.

Jobs's "expanded role" soon became more clear in terms of his responsibilities—Apple had no CEO, stock prices were at a five-year low, and important decisions needed to be made. Jobs was referred to as "interim CEO," and 1997 proved to be a landmark year for his company. MacWorld Boston was held in August, and Jobs was the keynote speaker. He used that event to make several significant announcements that would turn Apple around: There would be an almost entirely new board of directors, an aggressive advertising campaign, and an alliance with Microsoft. Microsoft received $150 million in Apple stock, Apple would have a five-year patent cross-license, and the old legal battle between the two companies would finally be resolved. As part of the resolution to the legal dispute, Microsoft paid an undisclosed amount to Apple to quiet the allegations that it had stolen Apple's intellectual property (the Mac GUI) and agreed to make Windows 98 available to Mac users by year's end. Jobs also effectively ended Apple's licensing agreements with other companies, buying out all but one, with the understanding that that company would serve only the low-end market for computers (under $1,000). At a late 1997 press conference, Jobs announced that Apple would begin selling direct to consumers over the Web and by phone. Within a week, the Apple store was the third largest e-commerce site on the Web.

Jobs continued to make several changes during 1998, a year in which Apple reported a profit in all four quarters. Apple's stock price was on the rise, and the company had released the iMac, an all-new design for the Macintosh that was meant to serve the lower-end consumer market. The computer had more than enough processing capabilities than most consumers would ever need and was priced affordably. In the fall of that year, the iMac was the best-selling computer in the United States. Apple followed up that success by introducing the iBook in 1999, the portable counterpart to the iMac, a laptop meant to be stylish, affordable, and powerful. Throughout 1999, Apple's stock continued to soar; in the fall it reached a high in the upper $70s.

In early 2000, Jobs announced that he was now permanent CEO of Apple. The remainder of that year was a slow one for Apple and for the rest of the computer industry. As a result, Apple reported its first quarterly loss in three years. In late 2000, the company cut prices across the board; then, in early 2001, it released a new set of PowerMacs with optical drives that let consumers both listen to and burn CDs as well as both read and write to DVDs. In May 2001, Jobs announced that Apple would open several retail stores that would sell Apple products as well as third-party products, including MP3 players, digital cameras, and digital video cameras.

In October 2001, Apple released the iPod—a product that revolutionized the company and the digital music player industry. In 2003, when the company released iTunes, the online retail store where consumers could purchase individual songs legally, the success of the venture skyrocketed. The technology was available only for Macs at first but had since become available for PC users as well. By July 2004, 100 million songs had been sold and iTunes had a 70 percent market share among all legal online music download services. Apple's success continued to grow, largely thanks to the iPod and iTunes.

By 2005, Jobs's leadership had placed Apple at the forefront of the digital music player industry and had established the company as a player once again in the computer industry. From the moment Jobs returned to Apple, he had idea after idea for how to improve the company and turn its performance around. He not only consistently pushed for innovative new ideas and products but also enforced several structural changes, including ridding the company of unprofitable segments and divisions. He managed to blend his leadership style, which epitomized the spirit and standards on which Apple was founded, with the business discipline the younger Jobs had lacked. Jobs also credited Apple's success to its skilled management team, including Tim Cook.

Timothy D. Cook was Apple's executive vice president of worldwide sales and operations. Cook reported to the CEO and managed Apple's supply chain, sales activities, and service and support in all markets and countries. His position was accountable for maintaining Apple's flexibility in serving more demanding consumers. Cook had worked first for IBM and then for Compaq, gaining extensive experience in technological industries. While Jobs provided the vision for the organization, Cook and the other members of the executive staff and the board of directors were responsible for ensuring that all operations of Apple ran efficiently and smoothly. Together they worked to ensure that Apple could continue to be a vital, innovative company in a very competitive environment. Cook took on the role of acting CEO after Steve Jobs took a leave of absence to determine the cause of his declining health, which became apparent to outsiders in fall 2008.

Apple's Situation in 2009

Under Cook's leadership, Apple's sales of computers, iPods, iPhones, and iTunes downloads allowed it to set annual revenue and earnings records in 2008—records that it appeared would be broken in 2009. The company reported its best-ever quarterly results in the third quarter of fiscal 2009 with revenues of $8.34 billion compared to $7.46 billion for the same quarter the previous year and a net quarterly profit of $1.23 billion, up from $1.07 billion during the same period in 2008. Apple shipped a record 2.6 million Macintosh units (up 4 percent from the same quarter the previous year) and 10.2 million iPods (a 7 percent decline from the same quarter the previous year), and 5.2 million iPhones (a 626 percent increase from the third quarter of 2008). A summary of Apple's financial performance for fiscal years 2005–2008 is provided in Exhibit 1.

Apple managed its businesses largely on a geographic basis. Its primary geographic segments included the Americas (North America and South America); Europe, Africa, and the Middle East; and Japan. It also had a Retail division that operated the Apple-owned stores in the United States, Italy, Japan, Canada, and the United Kingdom. The company's primary product lines were Macintosh products (including desktops and portables); iPods, iPhones; iTunes (including other music-related products and services); peripherals (including other hardware); and software, service, and other sales. The company's net sales by operating segment and product line and unit sales by product line for 2004 through 2008 are provided in Exhibit 2.

Exhibit1

Summary of Apple, Inc.'s Financial Performance, 2005–2008 (in millions, except share amounts, employees, and contractors)

	2008	2007	2006	2005
Net sales:				
Domestic	$18,469	$14,128	$11,486	$8,334
International	14,010	9,878	7,829	5,597
Total net sales	32,479	24,006	19,315	13,931
Costs and expenses:				
Cost of sales	21,334	15,852	13,717	9,889
Research and development (R&D)	1,109	782	712	535
Selling, general and administrative (SG&A)	3,761	2,963	2,433	1,864
Total operating expenses	4,870	3,745	3,145	2,399
Operating income	6,275	4,409	2,453	1,643
Other income and expense	620	599	365	165
Income before provision for income taxes	6,895	5,008	2,818	1,808
Provision for income taxes	2,061	1,512	829	480
Net income	$ 4,834	$ 3,496	$ 1,989	$1,328
Earnings per common share—Diluted	$ 5.36	$ 3.93	$ 2.27	$ 1.55
Shares used in computing earnings per share—Diluted (in thousands)	902,139	889,292	877,526	856,878
Financial position as of September of year				
Cash, cash equivalents, and short-term investments	$24,490	$15,386	$10,110	$8,261
Accounts receivable, net	2,422	1,637	1,252	895
Inventories	509	346	270	165
Property, plant, and equipment, net	2,455	1,832	1,281	817
Total assets	39,572	25,347	17,205	11,516
Current liabilities	14,092	9,299	6,443	3,487
Noncurrent liabilities	4,450	1,516	778	601
Shareholders' equity	$21,030	$14,532	$9,984	$7,428
Regular employees	32,010	21,550	17,787	14,806
Temporary employees and contractors	3,066	2,116	2,399	2,020
International net sales as a percentage of total net sales	43%	41%	41%	40%
Gross margin as a percentage of net sales	34.3%	34.0%	29.0%	29.0%
R&D as a percentage of net sales	3%	3%	4%	4%

Source: From Apple Investor Relations, http://media.corporate-ir.net/media_files/irol/10/107357/AAPL_3YR_Q407.pdf (accessed July 13, 2008); http://media.corporate-ir.net/media_files/irol/10/107357/AAPL_3YR_Q407.pdf (accessed July 13, 2008); and http://library.corporate-ir.net/library/10/107/107357/items/314467/AAPL_3YR_Q4FY08.pdf (accessed July 30, 2009).

PersonalC omputer Industry

In the second quarter of 2009, the worldwide PC market declined by 5 percent when compared to the second quarter of 2008. In the U.S. market, total shipments declined by a more modest 1.2 percent. The PC industry was relatively consolidated, with the U.S. market dominated by five sellers who collectively controlled 81.4 percent of the market—see Exhibit 3. Internationally, the top five computer manufacturers controlled 60.1 percent of the market, with Apple accounting for only 2 percent of international computer shipments. Prior to the onset of the recession that had impacted most developed countries, the PC industry had been expected to grow at a

Exhibit2

Apple, Inc.'s Net Sales by Operating Segment, Net Sales by Product, and Unit Sales by Product, 2004–2008 (in millions)

	2008	2007	2006	2005	2004
NET SALES BY OPERATING SEGMENT					
Americas net sales	$14,573	$11,596	$ 9,415	$ 6,950	$4,019
Europe net sales	7,622	5,460	4,096	3,073	1,799
Japan net sales	1,509	1,082	1,211	920	677
Retail net sales	6,315	4,115	3,246	2,350	1,185
Other segments net sales[a]	2,460	1,753	1,347	998	599
Total net sales	$32,479	$24,006	$19,315	$13,931	$8,279
NET SALES BY PRODUCT					
Desktops[b]	$ 5,603	$ 4,020	$ 3,319	$ 3,436	$2,373
Portables[c]	8,673	6,294	4,056	2,839	2,550
Total Macintosh net sales	$14,276	10,314	7,375	6,275	4,923
iPod	9,153	8,305	7,375	4,540	1,306
Other music-related products and services[d]	3,340	2,496	1,885	899	278
iPhone and related products and services[e]	1,844	123	—	—	—
Peripherals and other hardware[f]	1,659	1,260	1,100	1,126	951
Software, service, and other sales[g]	2,207	1,508	1,279	1,091	821
Total net sales	$32,479	$24,006	$19,315	$13,931	$8,279
UNIT SALES BY PRODUCT					
Desktops[b]	3,712	2,714	2,434	2,520	1,625
Portables[c]	6,003	4,337	2,869	2,014	1,665
Total Macintosh unit sales	9,715	7,051	5,303	4,534	3,290
Net sales per Macintosh unit sold[h]	$ 1,469	$ 1,463	$ 1,391	$ 1,384	$1,496
iPod unit sales	54,828	51,630	39,409	22,497	4,416
Net sales per iPod unit sold[i]	$ 167	$ 161	$ 195	$ 202	$ 296
iPhone unit sales	11,627	1,389	—	—	—

[a]Other segments include Asia Pacific and FileMaker.
[b]Includes iMac, eMac, Mac mini, Power Mac, and Xserve product lines.
[c]Includes MacBook, MacBook Pro, iBook. and PowerBook product lines.
[d]Consists of iTunes Music Store sales, iPod services, and Apple-branded and third-party iPod accessories.
[e]Derived from handset sales, carrier agreements, and Apple-branded and third-party iPhone accessories.
[f]Includes sales of Apple-branded and third-party displays, wireless connectivity and networking solutions, and other hardware accessories.
[g]Includes sales of Apple-branded operating system, application software, third-party software, AppleCare, and Internet services.
[h]Derived by dividing total Macintosh net sales by total Macintosh unit sales.
[i]Derived by dividing total iPod net sales by total iPod unit sales.

Source: Apple Inc., 10-K report filed with the SEC on November 15, 2007.

rate of 5–6 percent to reach $354 billion by 2012. However, the continuation of the U.S. recession beyond economists' projections caused most industry analysts to avoid making firm forecasts of future demand.

Apple'sC omputerO perations

Even though Apple's revenues were increasingly coming from noncomputer products, primarily the iPod and iPhone, the company still saw computers as its core business. Apple's proprietary operating system and strong graphics handling capabilities differentiated Macs from PCs, but many consumers and business users who owned PCs were hesitant to purchase a Mac because of Apple's premium pricing and because of the learning curve involved with mastering its proprietary operating system.

Exhibit3

U.S. PC Market Share, Second Quarter 2007, Second Quarter 2008, and Second Quarter 2009

COMPANY	Q2 2007	Q2 2008	Q2 2009
Dell Inc.	27.9%	31.6%	26.0%
Hewlett-Packard	25.8	25.1	25.7
Acer	10.6	8.0	14.2
Apple	6.4	8.4	8.7
Toshiba	5.6	5.5	6.8
Others	23.7	21.3	18.6

Source: www.gartner.com, October 2008; and "Gartner Says Worldwide PC Shipments Declined 5 Percent in Second Quarter of 2009," *Business Wire,* July 15, 2009.

Many analysts still projected that Apple's greatest opportunity for growth would come from the projected halo effect of iPods and iPhones and that some consumers (but probably not business users) might switch to Apple computers after purchasing an iPod or iPhone.

Apple's computer product line consisted of several models in various configurations. Its desktop lines included the Mac Pro (aimed at professional and business users); the iMac (targeted toward consumer, educational, and business use); and Mac mini (made specifically for consumer use). Apple had three notebook product lines as well: MacBook Pro (for professional and advanced consumer users), the MacBook (designed for education users and consumers), and the MacBook Air (designed for professional and consumer users). In both the desktop and notebook lines, the "Power" products were higher-end and offered more computing power at a premium price. The other models were lower on the price scale but still priced high relative to Wintel sellers.

The MacBook Air was Apple's most recent notebook introduction. The MacBook Air was designed to target users who valued both portability and power. The notebook featured a 13.3-inch screen, a full-size keyboard, a built-in video camera, and cutting-edge wireless connectivity. This sleek notebook was only 0.76 inches at its maximum height when closed and weighed only three pounds. The MacBook Air had won critical acclaim for both its design and its ease of use, and was one of the products helping Apple gain ground in the competitive computer industry. All Apple computers were priced at a steep premium compared to PCs and laptops offered by Dell, HP, and other rivals. The company lowered the prices of all computer models by 10 percent or more in June 2009, with the price of the MacBook Pro falling to $1,199 and the MacBook Air getting a $300 price cut to $1,499.

Competitors in the PC Market

DELL Dell, the industry leader in PC sales, recorded net revenues of $61.1 billion for the fiscal year 2009—see Exhibit 4. Dell's 2009 revenues included the effect of a fourth quarter year-over-year sales decline of 48 percent that reflected the effect of the U.S. recession on the PC industry. Of this revenue, about 29

Exhibit 4

Dell's Revenues by Product Category (% of total revenues)

PRODUCT CATEGORY	FISCAL YEAR ENDED JANUARY 30, 2009	FEBRUARY 1, 2008	FEBRUARY 2, 2007
Mobility products (notebooks etc.)	31%	28%	27%
Desktop PCs	29	32	34
Software and peripherals	17	16	16
Servers and networking hardware	10	11	10
Professional consulting and support services	9	9	9
Storage products	4	4	4
Totals	100%	100%	100%

Source: Dell Inc. 2008 and 2009 10-Ks.

percent came from sales of desktop PCs. These PCs ranged from low-end bargain desktops to high-end gaming setups with the latest hardware and software. However, competition in the desktop market was lowering the profitability of desktop sales. Dell, a company that attempted to be a low-cost provider through supply chain and distribution logistics, was beginning to see a shift in consumer demand toward mobility products (laptops, notebook computers, handheld computers, and tablet PCs). Dell's notebook computers, like its desktops, ranged from low-end, low-priced models to state-of-the-art, high-priced models. This segment showed promising revenue growth for Dell. The company also offered peripherals such as printers, monitors, projectors, and WiFi products as it attempted to move into a role as a consumer electronics provider along with its role as a PC manufacturer.

HEWLETT-PACKARD Hewlett-Packard's Personal Systems Group (PSG) accounted for about 35.7 percent of the company's 2008 revenues of $118 billion. Imaging and various services accounted for the second largest percentage of the company's revenues, at 24.8 percent. From 2007 to 2008, the PSG experienced revenue growth of 16.2 percent and a 22 percent increase in unit volume. The company's sales of desktop PCs grew by just 5 percent during 2008, while laptop revenues increased by 28 percent between 2007 and 2008. HP's strongest growth was in emerging markets. However, the company's sales fell by 13 percent during the first quarter of 2009 as businesses and consumers purchased fewer computers. Exhibit 5 provides the revenue contribution by PSG product line for 2005 through 2008. Like Dell, HP offered desktops and notebooks in various configurations, with prices determined by the features offered and hardware contained in the systems. HP also offered peripherals such as televisions and related media devices, and was well-known in the imaging and printer markets.

Exhibit 5

Hewlett-Packard Personal Systems Group, Net Revenue (in millions)

PRODUCT	2008	2007	2006	2005
Notebooks	$22,657	$17,650	$12,005	$ 9,763
Desktop PCs	16,626	15,889	14,641	14,406
Workstations	1,902	1,721	1,368	1,195
Handhelds	360	531	650	836
Other	750	618	502	541
Total	$42,295	$36,409	$29,166	$26,741

Source: Hewlett-Packard 2007 and 2008 10-Ks.

ACER Acer, a multinational manufacturer based in Taiwan, was founded in 1976 as Multitech, with 11 employees. In 1979, Acer designed the first mass-produced computer for export from Taiwan; in 1985, it founded Taiwan's first and largest franchised retail computer chain. The company was renamed Acer in 1987, and a decade later it purchased the mobile PC division of Texas Instruments. By 2008, Acer had become the world's third largest computer manufacturer. Acer's 2008 consolidated revenues rose by approximately 18 percent from the previous year, to reach $16.6 billion, while operating income increased by 38 percent, to reach $428.8 million. In addition, its 55 percent annual growth in global shipments during 2008 made it the industry's fastest growing PC manufacturer. Acer's largest geographic segment was Europe/Middle East/Africa, which accounted for 54.3 percent of the company's PC, desktop, and notebook sales. Acer had become the fastest growing PC sellers in the United States, largely as a result of its multi-brand strategy that positioned Acer, Gateway, eMachines, and Packard Bell at distinct price points in the market for PCs. The company based its competitive strategy on its four pillars of success: a winning business model, competitive products, an innovative marketing strategy, and an efficient operation model. The company's computer offering included desktop and mobile PCs, LCD monitors, servers and storage, and high-definition TVs and projectors. Heading into 2009, the company expected to be able to continue to increase revenues through its focus on low-priced notebook computers sold by U.S. discountc onsumere lectronicsr etailers.

PersonalM edia Player Industry

More than 100 companies manufactured personal media players in 2009, but only four of them legitimately claimed real importance in this market: Apple, Creative, SanDisk, and Microsoft. The digital personal media player market was clearly dominated by Apple, with it closest rival, SanDisk, capturing only 10 percent of the market (see Exhibit 6). The leading companies in the industry realized that their continued success depended not only on how well they could satisfy their current customers but also on their ability to attract new customers. Research indicated that most buyers based their choice of player on song capacity, multimedia capabilities, unit battery life, physical size and weight, and ease of use. Apple's success had proved that many consumers were willing to pay a premium for some perceived benefit, whether it was higher quality, more technological sophistication, or greater ease of use. Flash-based players were becoming increasingly popular with consumers, as were touch screens and Bluetooth connectivity. However, as the market matured, price was becoming an increasingly important factor in consumer decisions.

AppleiP od

For much of Apple's history, it had excelled at being the first company to introduce a concept or a new product, but then struggled to maintain control of its market share in that product line. Although Apple didn't introduce the first portable digital music player (EigerLabs did in 1998), the iPod, introduced in October 2001, was the first to gain widespread attention and popularity. When Apple launched its iPod, many critics did not give the product much of a chance for success, given its fairly hefty price tag of $399. However, the success of the iPod had reached such phenomenal proportions that one observer said, "It is now a fashion statement, and any other MP3 player is considered 'Brand X' for many consumers."[1] Industry experts agreed that the iPod's success had revolutionized the portable music industry in a manner similar to the Sony Walkman in 1980.

By June 2005, Apple controlled well over 70 percent of the hard drive digital music player market and more than 40 percent of the flash memory player market. In July 2009, Apple offered four basic styles in the iPod product line and controlled an estimated 70 percent of the combined flash memory and hard-drive-equipped digital music player market. The four iPod styles were as follows:

- The *iPod Shuffle*, a basic flash-based player with no screen, FM radio, or voice recorder. The 4GB model was capable of storing 1,000 songs and its rechargeable lithium polymer battery provided up to 10 hours of playbackt ime.
- The *iPod Nano* multimedia player, offered in 8GB (eight hours of video or 2,000 songs) and 16GB (16 hours of video or 4,000 songs) sizes, that used a click wheel interface to navigate the player's controls. It allowed users to view photos and videos as well as to listen to music (in Apple's AAC format). It provided up to 24 hours of music playback and four hours of video playback on a single charge.
- The *iPod Classic*, a hard-drive-based click-wheel-controlled multimedia player offered with a 120GB hard-drive that, similar to the smaller Nano, played music in Apple's AAC format and showed videos and photos. The 120GB player held up to 30,000 songs or 150 hours of video and provided up to 36 hours

Exhibit6

Digital Music Player Market Share (percentage based upon units sold)

	Q1 2007	Q1 2008
Apple	72%	71%
SanDisk	10	11
Creative	4	2
Microsoft	3	4
Others	11	12
Total	100%	100%

Source: NPD Group, May 12, 2008.

of audio playback or six hours of video playback on a single charge.

- The *iPod Touch,* a multimedia flash memory player controlled though an innovative touch screen interface that was a feature of the iPhone. It was offered in 8GB (1,750 songs, 10 hours of video), 16GB (3,500 songs, 20 hours of video), and 32GB (7,000 songs, 40 hours of video) sizes, and provided up to 22 hours of music playback and five hours of video playback on a single charge. This multimedia player featured a wide 3.5-inch screen and built-in Wi-Fi, which allowed users to connect to the Internet and access e-mail, buy music from the iTunes store, and surf the Web from wireless hotspots. Touch users also had access to maps, the weather, and stocks, and the ability to write notes to themselves. The Touch featured an accelerometer that detected when the Touch rotated and automatically changed the display from portrait to landscape.

While each new version of the iPod offered innovative technology, the new product introductions were not without their challenges. The original iPods were criticized for short battery life and eventually led to a class action lawsuit against Apple, with users claiming that Apple had misrepresented the life of the rechargeable battery used in the iPod. While Apple denied this claim, the company offered a battery replacement service for $99 and offered to settle the class action suit in June 2005, offering purchasers of first-, second-, and third-generation iPods an extended warranty and a $50 voucher. Apple also experienced problems with the launch of the Nano in 2005, with customers complaining about the device freezing and the ease with which the device (especially the screen) could be scratched or would stop functioning. Apple offered a repair and replacement service for these devices, but it was expected to face a class action suit as a result of these problems, similar to the one filed over the battery life problem.

Regardless of these challenges, a 2007 customer survey by *PC Magazine* showed that

Exhibit 7

PC Magazine Customer Satisfaction with MP3 Players—Reader Survey

MP3 PLAYERS	OVERALL	SOUND QUALITY	EASE OF USE	RELIABILITY
Apple	8.3	8.7	8.6	8.3
Microsoft	8.1	8.7	8.3	8.2
Creative	7.8	8.4	7.5	8.1
Archos	7.6	8.1	7.6	8.0
iRiver	7.6	8.4	7.2	8.1
Toshiba	7.6	8.5	8.1	8.0
SanDisk	7.5	8.0	7.5	7.9
Samsung	7.4	8.0	7.5	7.9
Sony	7.3	8.0	7.4	7.8
Average*	7.4	8.1	7.6	7.8

*Includes scores from Dell, Rio, Panasonic, Philips and RCA as well.

Source: Based on a *PC Magazine* customer survey, October 31, 2007, www.pcmag.com.

Apple iPods ranked significantly higher than other brands in terms of overall quality, sound quality, ease of use, and overall reliability—see Exhibit7 .

iTunes

Aside from the iPod's ease of use, one of the primary factors that contributed to the popularity of the iPod was Apple's iPod/iTunes combination. In fact, despite the acclaim that had been heaped on it, many industry observers believed that the iPod would not have achieved its dominant position without iTunes.

Apple first released the iTunes digital music management software for Macintosh computers in 2001. It was innovative but not alone. Originally, the software was intended to allow users to store their digital (CD) music to their computer hard drives and make the content easily accessible. As features such as the ability to burn custom CDs were added to the software, iTunes became more and more useful to consumers.

When the iPod was released in 2001, iTunes was quickly adjusted to allow for syncing between the music management software and the new music player. This interface made it easy for consumers to move content from their computer to their iPod, an essential part of the product value of the iPod. While the iTunes software was a key component in Apple's strategy, it would not have a significant impact on iPod sales until the iTunes fourth edition was released in April 2003.

With the release of the fourth edition, Steve Jobs announced that he had reached a deal with the five major music labels to sell their content in a copy-protected form from the iTunes Music Store on the Internet, and the world took notice. It marked the first time that such a large library of popular music was available in one place via a simple method. Jobs was able to negotiate the agreement with the labels for two main reasons. First, the labels were eager to offer a legitimate online source for their music that would reduce the flow of pirated music. Second, the music Apple provided from the iTunes Music Store was compressed using Apple's proprietary Advanced Audio Coding (AAC) and the music was protected with Apple's Fairplay Digital Rights Management system, one of the strongest in the country.

In October 2003, a version of iTunes, including the iTunes Music Store, was released for Windows users. This immediately opened up Apple's music store to millions of users who had previously been shut out. By October 2005 Apple had introduced a new version of iTunes that sold not only music but video as well. This version of iTunes was released in conjunction with Apple's video iPod. As in the original launch of iTunes, Apple formed partnerships with major networks such as ABC, NBC, ESPN, and Disney to make content such as television shows, sports programming, news, and children's shows available in a secure, encoded format.

In 2009, iTunes allowed customers not only to purchase music, videos, movies, and television shows that could be played on any of the iPods (with the exception of the Shuffle and the iPhone) but also to rent movies that could be played on the Apple iPods, iPhones, or Apple TV devices. Apple advertised that with a catalog of more than 10 million songs, and with more than 5 billion songs downloaded from the iTunes store since its introduction in 2001, iTunes was the number one music retailer in the United States. Additionally, Apple advertised iTunes as the world's most popular online movie store, with customers purchasing and renting more than 50,000 movies a day.

Competitors in the Personal Media Player Industry

CREATIVE Creative Labs (Creative) first became famous for its Sound Blaster sound cards, which set the standard in PC audio in 1989. Since that time, Creative had been an industry leader in PC audio technology and had built a large user base and strong brand name in this area. Leveraging this position, Creative offered the digital music player industry's broadest and most diverse product line:

- The Zen, a credit-card-sized multimedia flash-based player offered in 5 different submodels with hard drives ranging from 2GB to 32GB. All Zen submodels featured a 2.5-inch screen and allowed users to listen to music in Apple's AAC format as well as MP3 and WMA formats; to view video, including movies rented from online services; and to view photos. This innovative product was rated as one of the 100 best products of 2008 by *PC World.*
- The Zen Mozaic and Zen V were small-screen models (1.8 inch and 1.5 inch, respectively) that played digital or FM music and allowed users to view photos andv ideo.
- The Zen Stone line, which included the Zen Stone, the Zen Stone with Speaker, the Zen Stone Plus, and the Zen Stone Plus with Speaker. The Zen Stone line included flash-based players, from 1GB to 4GB, that were positioned to compete against Apple's iPod Shuffle. The most basic player, the Zen Stone, was a 1GB player that did not have a screen but was offered in six colors

and provided 10 hours of playback on one charge. The Zen Stone with Speaker was offered in 1GB and 2GB sizes and offered a battery life superior to that of the Zen Stone while also offering an external speaker so the device could be used without earphones. The Zen Stone Plus, offered in 2GB and 4GB sizes, had significantly more features, including a small screen, an FM radio, a voice recorder, a clock, and a stopwatch. The 2GB version provided 9.5 hours of playback per charge, while the 4GB offered 12 hours. The Zen Stone Plus with Speaker was essentially identical to the Zen Stone Plus, with the addition of an external speaker and a longer battery life (of up to 20 hours).

Creative was acknowledged as one of the leaders in innovation in the industry, having won the prestigious Consumer Electronics Show's Best of CES Award three years in a row with its Zen Portable Media Center in 2004, the Zen Microphoto in 2005, and the Zen Vision: M in 2006. In 2008, Creative introduced the Zen X-Fi (8GB), which used Creative's proprietary X-Fi Xtreme Fidelity Audio technology to enhance sound quality. This multimedia player featured a built-in speaker, a memory expansion slot, an FM radio, and voice recorder; also, it allowed users to watch movies, view photos, and play music in Apple's AAC format as well as in MP3 and the Windows WMA format. A significant edition to the X-Fi line was the Zen X-Fi with wireless, available in both 16GB and 32GB, which allowed users to stream music and photos as part of a home network and include Yahoo Messenger and Windows Live Messenger to allow users to stay in touch with their friends on the go.

In Creative's fiscal year ending June 30, 2008, the company reported an operating loss of $61 million but a net income of $28 million due to a $100 million payment from Apple for use of the Zen patent. This compared to an operating loss of $145 million in fiscal year 2006 and loss in net income of $126 million. The struggling company was voluntarily delisted from the NASDAQ stock exchange in 2007, and in March 2008 agreed to sell and lease back its headquarters building for $250 million in an effort to increase cash flows. The company's losses continued into fiscal 2009 with the company recording revenues of $380 million and a net loss of $106 million during the nine-month period ending March 31, 2009.

IRIVER iRiver Inc. was owned by Reigncom Ltd., based in South Korea. The company entered the digital music player market relatively early and offered a wide variety of MP3 players worldwide. The brand was especially strong in Korea, where it controlled more than 50 percent of the Korean MP3 player market at one time. However, in 2008 iRiver offered only four styles of players in the U.S. market: the E100, the iRiver Clix, the T60, and the L Series.

Leading the company's product line was the popular and critically acclaimed iRiver Clix, which had won multiple awards, such as an Editor's Choice Award and a World Class Award from *PC World*, and was featured as one of *PC World*'s Top 100 Products of the Year for 2006. *Consumer Reports* (a leading consumer advocate magazine that regularly rated and ranked products) rated the Clix as its top flash player as of April 1, 2007, placing it above players from Apple and SanDisk, among other manufacturers. In 2008, iRiver offered the second-generation Clix in 2GB, 4GB, and 8GB models. The Clix GEN2 offered 24 hours of battery life; played music, videos, and photos; supported subscription music services; and featured a built-in digital FM tuner.

The iRiver T7 was a relatively basic flash-based player that was offered in 2GB and 4GB sizes. The T7 series played music files (including MP3, WMA, and OMG) and featured a small screen, an FM tuner and recorder, and a voice recorder. The e100 flash-based player was launched in April 2008 and was offered in 4GB and 8GB sizes. This multimedia player featured a sleek, sophisticated design, high-quality playback, an FM radio, and a voice recorder, and offered up to five hours of video playback and up to 18 hours of audio. The iRiver Spinn was a stylish credit-card-sized audio and video player that had a 3.3 inch LCD display. The Spinn was available with flash memory of 4GB or 8GB. The Clix and Lplayer were also credit-card-sized media players with large screens. The Lplayer came equipped with either 4GB or 8GB flash memory, while the Clix had flash memory of 2GB or 4GB. The Spinn, Clix, and Lplayer played audio and video files and featured high-quality graphics, touch screen navigation, FM radio and recording, and voice recording.

MICROSOFT Microsoft Corporation, one of the best known companies in the world, was a late entrant into the MP3 player market, not releasing its Zune brand until November 2006. In 2009, the Zune flash-based players were offered in 4GB, 8GB, and 16GB sizes, and the Zune hard-disk players came in 80GB and 120GB sizes. The Zune flash-based players played both audio and video files and featured a 1.8-inch glass screen, the ability to wirelessly sync music with the user's home network, a built-in FM radio, and access to the Zune Marketplace, an online store that was Microsoft's answer to the iTunes store. The Zune could also be plugged into an Xbox 360 to customize the sound track of games played on the system. The 80GB and 120GB player offered all of the features of the flash-based players but also offered a 3.2-inch screen. The larger 120GB player held up to 30,000 songs, 25,000 pictures, or 375 hours of video. One of the primary distinguishing characteristics of the Zune was its wireless connectivity, which allowed users to share music and photos with other users within 30 feet. A user who received "beamed" songs could listen to the song three times before the Zune's built-in digital rights management (DRM) software prohibited access to the song. Photos had no such limitation. To highlight the song-sharing capability of the Zune, Microsoft marketed the product with the tag line "Welcome to the Social."

Microsoft viewed the Zune's networking feature as a critical element of its strategy for the Zune brand. According to J. Allard, who was charged with overseeing the development of the Zune, Microsoft intended to place this player, and future Zune products, at the center of an "ecosystem" that "helps bring artists closer to their audience and helps people find new music and develop social connections."[2] To further support the ecosystem, Microsoft enlisted more than 100 partners to aid in product development, to offer accessories for the Zune, and to provide content on the Zune Marketplace. Users could access the Zune Marketplace through the software included with the Zune. At the Zune Marketplace, they could purchase accessories for their Zune or select from more than 2 million songs, which they could buy outright or access through an "all you can eat" subscription service known as Zune Pass. For $14.99 a month, the Zune Pass allowed users to download as many songs as they wanted from the Zune Marketplace, but once the subscription expired, users could no longer access the downloadeds ongs.

SANDISK Like Microsoft, SanDisk was a relatively new entrant in the MP3 player industry. SanDisk was founded in 1988 and headquartered in Milpitas, California. The company was the leading worldwide supplier of innovative flash memory storage products and leveraged this market position when it integrated forward and shipped its first flash-based players in May 2005. By June 2005, the company had captured 8.9 percent of the flash memory digital music player market.

By July 2009, the company's digital music player portfolio featured 3 models of players:

- The *Sansa View,* available in 8GB, 16GB, and 32GB sizes, was introduced in January 2007 and was considered to be the flagship product from SanDisk. The Sansa View players featured a 2.4-inch screen, a built-in FM radio, an expandable memory slot, and a built-in microphone for recording. The 32GB player offered up to 35 hours of audio playback on a single battery charge and could hold up to

48 two-hour movies, 8,000 MP3 songs, or 16,000 photos.

- The *Sansa Fuze* was a multimedia player that played videos, music, and audiobooks. The Sansa Fuze was available in 2GB, 4GB, and 8GB sizes and featured a digital FM radio, voice recording with a built-in microphone, an expandable memory slot, and up to 24 hours of audio playback on a single battery charge.
- The *Sansa Clip* was a compact, wearable flash-based MP3 player that included a small screen and was offered in 1GB, 2GB, 4GB, and 8GB capacities. This relatively basic player featured an FM tuner, a voice recorder with a built-in microphone, and up to 15 hours of play time on a single charge.

SanDisk was considered by many analysts to be the second strongest competitor in the MP3 player industry and the strongest in the Windows-based segment. SanDisk had made significant strides in the market by offering more features at a lower price than its rivals. For example, the Connect was positioned to compete directly with the iPod Nano, given the Connect's WiFi capabilities, larger screen, expansion slot, and lower price point. The company also attributed its success to aggressive marketing campaigns and retailers who were looking to improve on the razor-thin profit margins Apple allowed its retailers. However, the company was significantly affected by the fierce competition in the MP3 player industry and the volatile flash memory market. In response to falling profits, the company took measures to reduce production costs and operating expenses. Even with this temporary setback, many analysts viewed SanDisk as the leading challenger to Apple and the main rival for Microsoft to overtake in the fiercely competitive Windows-based MP3 player market.

AppleiP hone

The iPhone, Apple's Internet-enabled multimedia cellular phone, was considered to be a key product in the future of the company's product portfolio. The first version of the iPhone was released on June 29, 2007. It had a multitouch screen with a virtual keyboard and buttons but a minimal amount of hardware input. The iPhone's functions included those of a camera phone and portable media player (equivalent to the iPod) in addition to text messaging and visual voice mail. It also offered Internet services including e-mail, Web browsing (using access to Apple's Safari Web browser), and local Wi-Fi connectivity. The iPhone was named *Time* magazine's Invention of the Year in 2007.

The iPhone began with Apple CEO Steve Jobs's direction that Apple engineers investigate touch screens. Apple created the device during a secretive and unprecedented collaboration with AT&T Mobility (which was Cingular Wireless at the time of the phone's inception), at a development cost of $150 million by one estimate. During development, the iPhone was code-named Purple 2. The company rejected an early "design by committee" built with Motorola in favor of engineering a custom operating system and interface and building custom hardware. More than 270,000 first generation iPhones were sold during the first 30 hours of its launch.

On September 5, 2007, the 4GB model was discontinued and the 8GB model price reduced to $399. Those who had purchased an iPhone in the 14-day period before the September 5, 2007, announcement were eligible for a $200 "price protection" rebate from Apple or AT&T. However, it was widely reported that some who bought between the June 29, 2007, launch and the August 22, 2007, price protection kick-in date complained that this was a larger-than-normal price drop for such a relatively short period and accused Apple of unfair pricing. In response to the controversy, on September 6, 2007, Apple CEO Steve Jobs wrote in an open letter to iPhone customers that everyone who purchased an iPhone at the higher price "and who is not receiving a rebate or other consideration," would receive a $100 credit toward the purchase of any product sold in Apple's retail or online stores.

The iPhone 3G was released in 70 countries on July 11, 2008, and was available in the United States exclusively on AT&T Mobility with a two-year contract. The new Apple iPhone 3G combined the functionality of a wireless phone and an iPod and allowed users to access the Internet wirelessly at twice the speed of the previous version of the iPhone. Apple's new phone also featured a built-in GPS and, in an effort to increase adoption by corporate users, was compatible with Microsoft Exchange.

The iPhone 3GS was introduced on June 19, 2009, and included all of the features of the iPhone 3G, but could launch applications and render Web pages twice as fast as the iPhone 3G. The iPhone 3GS also featured a three-megapixel camera, video recording, voice control, and up to 32 GB of flash memory. The iPhone 3GS 16GB model was priced at $199 on a two-year AT&T contract, while the 32GB model was priced at $299 on a two-year AT&T contract. Upgrade prices without a contract renewal were $399 and $499, respectively, for the 16GB and 32GB models.

Similar to the iTunes/iPod partnership, Apple launched the App Store for the iPhone. The App Store allowed developers to build applications for the iPhone and to offer them either for free or for a fee. On launch day, there were more than 800 applications available. Two hundred of these were available for free, while 90 percent of the applications cost less than $10. By the end of the launch weekend, the App Store reported more than 10 million downloads. In July 2009, the App Store had more than 65,000 applications created by 100,000 developers and 1.5 billion downloads. To further expand the interconnectivity between its product offerings, including the iPhone, Apple launched its MobileMe service on June 9, 2008. Like Microsoft Exchange, this service delivered push e-mail, contacts, and calendars to applications on the iPhone, iPod touch, Macs, and PCs.

While mobile phone sales had grown by just 5 percent in 2008 and were expected to decline by 4 percent in 2009, the smart phone segment had grown by 27 percent in 2008 and was projected to increase by 9 percent in 2009.

Exhibit 8

Market Shares for the Leading Sellers of Smart Phones, 2006–First Quarter 2009

BRAND	2006	2007	2008	Q1 2009
Nokia	49%	49%	44%	41%
Research in Motion	7	10	17	20
Apple	—	3	8	11
Others	44	38	31	28
Total	100%	100%	100%	100%

Source: Gartner (as reported in Jessi Hempel, "Smartphone Wars: Blackberry's Plan to Win," *Fortune,* August 17, 2009 (http://money.cnn.com/2009/08/12/technology/blackberry_research_in_motion.fortune/index.htm).

Nokia had been the the leading seller of smart phones between 2006 and the first quarter of 2009, although its market share had fallen as Research in Motion's Blackberry smart phones and Apple's iPhone became highly sought after by business users and consumers. Exhibit 8 presents market shares for the leading smart phone brands between 2006 and the first quarter of 2009.

The Future

In assessing Apple's future, most analysts agreed that Apple would undoubtedly continue its well-established track record of introducing innovative, high-quality consumer electronics to the masses. However, many believed that it would be very difficult for Apple to maintain its growth and substantial operating profit margins given increasing competition in its core markets and the economic pressures on the consumer technology sector.

Analysts were also concerned with Steve Jobs's health—his previous battle with cancer and recent liver transplant created questions about how effective he would be as CEO. Also, given Steve Jobs's health, many analysts questioned whether Apple should develop a formal succession plan that would eventually make chief operating officer Tim Cook Apple's CEO.

Also, falling demand in the personal media player market, and an increasing number of iPhone killers being offered by smart phone rivals Nokia and Research in Motion, and new models being developed by Samsung and LG, caused some analysts to question whether Apple's strategy could sustain its advantage in the industry.

Endnotes

[1] As quoted in Steve Smith, "iPod's Lessons," *Twice New York* 19, no. 15 (July 26, 2004), p.12.

[2] As quoted in Steven Levy, "Trying Apple's Tune," *Newsweek* online, September 17, 2006, www.msnbc.msn.com/id/14866932/site/newsweek (accessed April 10, 2007).

Case 7

Nintendo's Strategy in 2009: The Ongoing Battle with Microsoft and Sony

Lou Marino
TheU niversityo fAl abama

Sally Sarrett
TheU niversityo fAl abama

The battle for market supremacy in the console segment of the video game industry began in earnest during the 2006 holiday retail season when Sony and Nintendo launched their latest-generation consoles to compete with the Xbox 360, which came to market in time for the 2005 Christmas shopping season. Video game analysts and writers for gaming magazines and Web sites marveled at the graphics-rendering capabilities of the Sony PlayStation 3 (PS3), which boasted a 3.2 GHz microprocessor, 550 MHz graphics card, 1080p HD resolution, Wi-Fi capabilities, a 60 GB hard drive and an HD Blu-ray optical drive. The PS3 matched the Microsoft Xbox 360 feature-by-feature and its Blu-ray drive was far superior to the standard DVD optical drive utilized by the Xbox 360. The only criticism of the PS3 was its astronomical introductory retail pricing of $499 to $599.

With Sony and Microsoft fully engaged in a technology war, video game analysts and writers were shocked by the technological limitations of the Nintendo Wii, which did not even match the graphics and processing capabilities of Microsoft's first-generation Xbox and had only slightly more computing power than the sixth-generation PlayStation 2 (PS2). Many industry analysts and hard-core gamers viewed the Wii as a toy, deriding the system for its weak graphics, lack of DVD playback, and childish name. Some video game industry analysts viewed the Wii as the last-ditch effort of a struggling company that had once dominated the global video game industry and then become increasingly irrelevant after Sony entered the market with its first PlayStation.

Interestingly enough, Nintendo didn't disagree that the Wii did not offer the best-quality graphics and did not include an extensive array of features and capabilities. In fact, while the Wii was in the developmental stage, Nintendo's CEO Satoru Iwata preferred not to speak of the Wii as a "next-generation" video game console, since this implied it would be an evolutionary improvement over the Game Cube, which had achieved a small global market share against the wildly popular PS2 and the modestly popular Xbox. Given Nintendo's declining sales and market share in the video game console segment since 2000, Iwata wanted to totally change the market's perception of the Wii by providing an entirely different video game playing experience that would be less intimidating to casual gamers and to people who had not previously played video games. The concept underlying the Wii—with its innovative and distinctively different controller—was to build on the company's success with the innovative user interface on the popular handheld Nintendo DS video game player.

While Nintendo's strategy for the Wii of concentrating on pioneering a daringly different video game controller (as opposed to building a raft of new graphics features and technological capability into the console itself) was viewed as very risky, it had proved to be spectacularly successful through 2009. Indeed, Nintendo quickly sold out of Wiis in the 2006 holiday season and sold all the Wiis it could produce throughout 2007 and 2008. Going into the 2009 holiday retail season, Nintendo's cumulative sales of the Wii far surpassed those of the PS3 and the Xbox 360. Nintendo's Wii, to the surprise of most everyone, was the market leader in sales of seventh-generation video game consoles.

Both Microsoft and Sony launched counterattacks against the Wii in 2008 and early 2009, including software releases targeting casual gamers, new controllers that allowed gamers to play in ways similar to Nintendo's controllers, and price cuts. Perhaps Nintendo's biggest threat was the international recession that began in late 2007 and was affecting many developed countries, including the United States. Video game console and software sales had been relatively unaffected by the recession until mid-2009. Video game industry revenues of $1.2 billion during the month of June 2009 were 31 percent less than the revenues of $1.7 billion recorded in June 2008. The quarterly decline in industry revenues was the steepest decline in industry sales since September 2000. Sales of consoles were affected the greatest by the recession, with June 2009 console sales falling by 38 percent to $382.6 million compared to June 2008 revenues of $617.3 million. The sales of Nintendo Wii units declined from 5.17 million during the quarter ended June 30, 2008, to 2.23 million during the quarter ended June 30, 2009. In addition, worldwide sales of Nintendo DS handheld gaming systems declined by 14 percent during the quarter and Nintendo's sales of video game software declined from 40.41 million units in the quarter ended June 30, 2008, to 31.07 million units in same quarter in 2009. The worsening economy and fresh attacks from Nintendo's chief rivals called for the company's senior managers to evaluate the company's strategy to avoid continuing declines in profits, which had fallen by 61 percent during its most recentqu arter.

Company History and Background

The playing card manufacturer founded in 1889 in Kyoto, Japan, eventually became known as the Nintendo Company Ltd. in 1963 when it expanded outside playing cards to other types of games. The company had produced electronic toys as early as 1970, but its 1981 introduction of a coin-operated video game called Donkey Kong transformed the company into a household name in North America, Asia, and Europe. The company formed a North American subsidiary headquartered in Seattle, Washington, in 1982 and, in 1983, launched the Family Computer home video gaming system in Japan along with adaptations of many of its most popular arcade titles. In 1985, the Family Computer home video gaming system was released in the United States as the Nintendo Entertainment System (NES); one of the video games available for play on the new NES system was the home version of Super Mario Brothers arcade game, a title that went on to rank as one of Nintendo's top-selling games of all time.

Nintendo introduced a handheld Game Boy device in 1989 that quickly became one of the world's best-selling video game playing systems. In 1991, Nintendo introduced the Super Nintendo Entertainment System (SNES); it had better graphics and stereo sound and was accompanied by a bigger selection and variety of games. The Nintendo 64 gaming system, a third-generation gaming system, was introduced in 1996; the N64's immense popularity drove Nintendo's revenues to record highs. It was followed by the also successful Game Boy Advance (2001) and a fourth-generation console system called GameCube (2001); while worldwide sales of the GameCube totaled 21.7 million units, it was considered by most video game enthusiasts as inferior to Sony's wildly popular PlayStation and PS2 and Microsoft's new Xbox.

Nintendo introduced the Nintendo Dual Screen (DS) in 2004 to combat increasing competition within the handheld video gaming console market segment. Sales of the DS quickly took off, with sales surpassing 50 million units worldwide by September 2007—a sales volume that made it the fastest-selling handheld video game console of all time. Nintendo introduced the DS Lite—a sleeker redesigned version of the DS—in 2006; it, too, was a market success. But Nintendo's major new product introduction in 2006 was the Wii, with its highly innovative wireless remote controller. Exhibit 1 provides the release dates and total units sold as of July 31, 2009, for Nintendo consoles and handheld systems launched between 1983 and 2006. Nintendo's consolidated statements of income for the fiscal year ending March 31, 2005, through fiscal year ending March 31, 2009, are presented in Exhibit 2. Its consolidated balance sheets for fiscal 2005 through fiscal 2009 are presented in Exhibit 3.

Nintendo's Handheld Game Systems

Handheld game systems were portable, lightweight electronic devices that included built-in speakers and displays designed largely for playing video games. The first handheld systems were introduced in the 1970s and 1980s, but the market had been largely dominated by Nintendo since its release of the Game Boy in 1989. The two main competitors in handheld game players in 2008 were the Nintendo DS and the Sony PlayStation Portable (PSP).

NintendoG ameBo y

The Nintendo Game Boy was Nintendo's first handheld video gaming device; it was conceptualized and developed by Gunpei Yokoi, a long-time Nintendo employee. Yokoi's goal was to create a product (1) that was lightweight, durable, inexpensive, and small in overall size and (2) that had its own spectrum of recognizable games. The Game Boy could be powered with either disposable or rechargeable batteries. Nintendo's Tetris game—specially designed for the Game Boy—proved quite popular and was a factor in making the Game Boy a resounding market success. Game Boy's success in the handheld market soon led Nintendo to introduce many new versions: Game Boy Pocket (a smaller, lighter unit requiring fewer batteries); Game Boy Light (with a backlight); Game Boy Color (with a color screen); Game Boy Advance (with a higher-resolution screen and improved

Exhibit 1

Estimated Total Sales of Nintendo Video Game Systems as of July 31, 2009

GAMING SYSTEM	DATE FIRST RELEASED	CUMULATIVE UNITS SOLD (IN MILLIONS)
Video Game Consoles		
Nintendo Entertainment System (NES)	July 15, 1983	61.90
Super Nintendo Entertainment System (SNES)	November 21, 1990	49.10
Nintendo 64 (N64)	June 23, 1996	32.90
Nintendo GameCube (GCN)	September 14, 2001	21.74
Nintendo Wii	November 19, 2006	51.60
Handheld Game Systems		
Game Boy and Game Boy Color	April 21, 1989 and October 21, 1998	118.70
Game Boy Advance	March 21, 2001	81.06
Game Boy Advance SP	February 14, 2003	43.23
Game Boy Micro	September 13, 2005	2.50
Nintendo DS/DS Lite	November 21, 2004	107.24

Source: Compiled by the case researchers from a variety of sources.

Exhibit 2

Nintendo's Consolidated Statements of Income, Fiscal 2005–Fiscal 2009 (in millions of U.S. dollars)

	3/31/2009	3/31/2008	3/31/2007	3/31/2006	3/31/2005
Total Revenues	$19,308.1	$16,557.0	$9,568.7	$5,041.6	$5,098.4
Cost of Sales	10,973.8	9,626.4	5,630.3	2,911.9	2,946.4
Gross Profit	8,334.3	6,930.6	3,938.3	2,129.6	2,152.0
Selling, General, and Administrative Expenses	2,503.3	2,105.4	1,697.3	1,225.6	1,028.8
Operating Income	5,831.0	4,825.2	2,241.0	904.1	1,123.2
Other Income (Interest and Other)	337.7	437.2	336.5	222.7	133.8
Currency Exchange Gains (Loss)	1,406.2	(914.2)	254.8	450.6	216.3
Other Nonoperating Income (Expenses)	50.7	17.5	30.5	23.7	(17.8)
EBT, Excluding Unusual Items	4,711.9	4,365.7	2,862.8	1,601.1	1,455.5
Gain (Loss) on Sale of Investments	(7.9)	(107.7)	5.5	35.0	(16.0)
Gain (Loss) on Sale of Assets	(0.6)	36.3	(1.3)	(0.2)	—
Other Unusual Items	2.6	—	—	12.2	—
Unusual Items, Total	(5.9)	—	—	12.2	—
EBT, Including Unusual Items	4,706.0	4,294.4	2,867.0	1,648.1	1,439.5
Income Tax Expense	1,776.1	1,747.7	1,141.9	674.6	573.8
Minority Interest in Earnings	(1.0)	1.0	0.4	0.5	(0.2)
Net Income	$ 2,930.8	$ 2,547.7	$1,725.5	$ 973.9	$ 865.4

Source: Nintendo Company Limited Annual Reports and financial releases.

visual technology); Game Boy Advance SP (with backlighting, a flip-up screen, and rechargeable batteries as well as other solutions to problems with the original Game Boy Advance model); and Game Boy Micro (the third version of the Game Boy Advance system, the smallest Game Boy created, with the same resolution but higher visual quality).

NintendoDS

In 2004, Nintendo released the Nintendo DS, a handheld video gaming system with a clamshell casing similar to that of the Game Boy Advance. The Nintendo DS had "dueling" screens on the top and bottom of the shell, and the bottom display was an LCD touch screen. The lower screen of the Nintendo DS was a touch-sensitive LCD designed to be pressed with a stylus, a user's finger, or a special thumb pad (a small plastic pad attached to the console's wrist strap that could be affixed to the thumb to simulate an analog stick). The DS was also equipped with a built-in microphone and Wi-Fi capability, which allowed its players to connectively network with one another's handheld systems to create a more interactive gaming experience.

Nintendo viewed the DS as a "third pillar" product with features that set it apart from the Game Boy Advance and the GameCube and that provided players with a unique entertainment experience. Nintendo President Satoru Iwata said:

> We believe that the Nintendo DS will change the way people play video games and our mission remains to expand the game play experience. Nintendo DS caters for the needs of all gamers whether for more dedicated gamers who want the real challenge they expect, or the more casual gamers who want quick, pick up and play fun.[1]

After its launch in November 2004, the Nintendo DS did remarkably well due to superior marketing and growing demand for the product, significantly boosting the company's overall revenues and profits. The Nintendo DS system had achieved about a 70 percent market share of all handheld video game players.

Exhibit 3

Nintendo's Consolidated Balance Sheets, Fiscal 2005–Fiscal 2009 (in millions of U.S. dollars)

	3/31/2009	3/31/2008	3/31/2007	3/31/2006	3/31/2005
Assets					
Cash and Equivalents	$ 7,941.2	$10,925.1	$ 6,818.5	$ 6,109.7	$ 7,848.0
Short-Term Investments	4,872.1	1,472.9	3,855.4	2,566.2	538.7
Accounts Receivable	1,461.5	1,441.5	869.0	418.9	487.7
Inventory	1,520.1	1,037.9	877.2	305.3	492.6
Deferred Tax Assets, Current	463.7	376.5	352.7	239.3	193.2
Other Current Assets	1,055.2	1,049.7	1,034.4	446.1	279.3
Total Current Assets	17,313.9	16,303.7	13,807.3	10,085.4	9,839.5
Net Property Plant and Equipment	746.3	546.0	570.2	554.1	538.8
Long-Term Investments	574.7	730.2	914.9	596.1	726.6
Deferred Tax Assets, Long Term	310.5	233.1	142.7	102.1	100.5
Other Intangibles	22.8	19.9	5.0	3.2	—
Other Long-Term Assets	47.5	11.9	158.3	150.1	6.2
Total Assets	$19,015.6	$17,844.7	$15,598.4	$11,491.0	$11,211.7
Liabilities & Equity					
Accounts Payable	3,746.6	3,324.6	2,980.7	829.8	1,271.5
Accrued Expenses	20.3	18.3	17.6	17.1	—
Current Income Taxes Payable	877.4	1,113.3	891.1	525.1	514.3
Other Current Liabilities, Total	1,036.0	1,159.3	748.1	432.5	248.2
Total Current Liabilities	5,680.4	5,615.5	4,637.5	1,804.5	2,034.0
Pension & Other Post-Retirement Benefits	107.6	44.6	44.0	32.7	48.4
Other Noncurrent Liabilities	59.6	8.8	8.3	10.3	6.8
Total Liabilities	5,847.5	5,668.9	4,689.8	1,847.5	2,089.1
Common Stock	105.7	99.6	99.6	99.6	99.6
Additional Paid in Capital	123.1	115.2	114.7	114.7	114.7
Retained Earnings	15,048.1	13,666.3	12,080.9	10,851.1	10,225.1
Treasury Stock	(1,643.6)	(1,546.2)	(1,538.4)	(1,535.6)	(1,286.0)
Comprehensive Income and Other	—	(159.2)	151.8	113.6	(30.9)
Total Equity	13,633.3	12,175.8	10,908.6	9,643.5	9,122.5
Total Liabilities and Equity	$19,015.6	$17,844.7	$15,598.4	$11,491.0	$11,211.7

Source: Nintendo Company Limited Annual Reports and financial releases.

By August 2009, Nintendo had sold more than 107 million DS handheld game systems units since its introduction. Additionally, Nintendo had sold more than 500 million copies of video games for its DS game systems.

Nintendo's Video Game Consoles

A video game console was an electronic device designed to be used with an external display device (e.g., a television or a monitor) that enabled people to play a variety of games stored on external media (e.g., cartridges or discs). The most recent consoles included hard drives that could be used to download and store games. Consoles were larger and more powerful than handheld systems. Personal computers could also be used to play video games, as could arcade machines designed for commercial use. Over the years, Nintendo had introduced five generations of consoles: the Nintendo Entertainment System (NES), the Super Nintendo Entertainment System (SNES), Nintendo 64 (N64), the Nintendo GameCube (GCN), and the Nintendo Wii.

NintendoE ntertainment System

The Nintendo Entertainment System (NES) was the most successful gaming system of its time, selling almost 62 million NES units worldwide (see Exhibit 1). The system proved a tremendous success for Nintendo while simultaneously revitalizing the video gaming industry, which had taken a serious downturn in the early 1980s. The NES system was Nintendo's first cartridge-based home gaming console, although the company had developed several models of successful arcade gaming systems.

SuperN intendoE ntertainment System

The Super Nintendo Entertainment System (SNES) was Nintendo's second home gaming console and appeared on the market as part of the fourth generation of video game consoles that various companies had introduced throughout the industry's history. SNES, with its vastly upgraded graphics and sound capabilities, was the most successful 16-bit gaming console manufactured in its generation, selling over 49 million units worldwide despite having a relatively slow central processing unit (CPU) in comparison to rival game-playing systems.

Nintendo6 4

The video game industry's fifth-generation home game consoles included the Sega's Saturn, Sony's PlayStation, and the Nintendo 64 (N64). In terms of the number of units sold, the N64 with cumulative sales of nearly 33 million units ranked second in its generation behind the PlayStation with cumulative sales of 102.5 million units. Nintendo's developers struggled with the question of whether the N64 should have a cartridge-based memory or a disc-based memory. Their choice of sticking with a traditional cartridge-based system was said to be one of the major reasons why the N64 was unable to compete effectively with Sony's highly popular PlayStation.

NintendoG ameCube

Nintendo's GameCube console gaming system was first introduced in Japan in September 2001. It was less expensive and more compact than Microsoft's Xbox and Sony's PS2, but lacked many of the graphics capabilities that attracted gamers to the Xbox and PS2. The GameCube was Nintendo's first system that did not use a cartridge storage method—instead it used optical discs. But it had disappointing global sales of only 21.72 million units.

Nintendo Wii

The Wii was Nintendo's latest gaming console system. Sales of the Wii exceeded all expectations. As of July 31, 2009, Nintendo had sold a total of 51.6 million Wii cosoles. Sales of the Wii were well above the Xbox 360's cumulative sales of 31.35 million units and the PlayStation 3's cumulative sales of 23 million. Nintendo's sales of games for the Wii exceeded 150 million units.

Nintendo engineers began designing the Wii gaming system in 2001, the same year that Nintendo introduced the GameCube. Originally referred to by its code name of Revolution, the Wii gaming system quickly became the benchmark for the Nintendo product line, bringing together research, innovation, technology, and functionality to create a revolutionary Bluetooth-activated wireless controller that provided a wide range of motion possibilities and allowed game players to control a game's characters through comparable movements of their own. Thus, players playing tennis imagined that the controller was their racket and the swinging motion with their arm triggered the character to act simultaneously. Indeed, the driving concept for the development of the Wii was to allow users to get up, move around the room, interact, and become a physical part of the game they were playing. "By giving players the ability to physically interact with a virtual world, Nintendo has significantly changed the experience of video gaming. It's suddenly more immersive, more compelling and potentially more appealing to consumers who have never considered buying a videogame console before," said David M. Ewalt, a writer who reviewed the Wii after its release. The inspiration and capabilities for Nintendo's new user interface came, at least partially, from Nintendo's success with the DS, the company's successes with games such as Nintendo Duck Hunt, which used a gun controller, and Track and Field, which employed an exercise mat to allow users to participate in athletic events on their SNES consoles.

Nintendo developers chose the name *Wii* for the gaming system because it was a phonic allegory that linked the name of the system to its intended user. One member of the development team for the Wii system was quoted as saying, "Wii sounds like 'we,' which emphasizes this console is for everyone. People around the world can easily remember Wii no matter what language they speak. No confusion. Wii has a distinctive 'ii' spelling that symbolizes both the unique controllers and the image of people gathering to play." The two *i*s in *Wii* were also a visual representation meant to resemble the system's controller design, as well as two people standing side by side, insinuating interaction and play together.

Nintendo marketers carefully analyzed rival products, trends in the video game marketplace, and their targeted segments of the population. Several characteristics stood out. As competition had increased and the market for video game products had become more saturated, Nintendo marketers paid particular attention to the fact that the concept, design, and functionality of rival video game consoles had become increasingly similar and offered increasingly similar game-playing experiences. As a consequence of weakening differentiation among new game playing devices, marketing strategies for gaining sales and market share became price-oriented. The penetration pricing strategies of the major rivals took on a "price war" character that squeezed profit margins and limited the potential for market share gains. When any particular company announced a new product and market entry strategy, it could expect a competitor to release a relatively similar product, usually within several months. In order to significantly grow the company's market share, Nintendo's executives believed that it had to focus on creating product differentiation advantages over competitors—typically by assessing what competitors were doing and generating ways to accomplish the same thing "better." The gaming market had become an arena for companies to "try to outperform their rivals to grab a greater share of existing demand."[2]

Thus, the marketers with Nintendo began developing a new strategy for the Wii system, and when the development of the Wii gaming system began, Nintendo designers had a new market in mind to appeal to. According to Shugery Miyamoto, a member of Nintendo's Wii development team, "We started with the idea that we wanted to come up with a unique game interface. The consensus was that power isn't everything for a console. Too many powerful consoles can't coexist. It's like having only ferocious dinosaurs. They might fight and hasten their own extinction."[3] Accordingly, the team decided to develop a system to attract people who generally did not play video games. This new market segment included populations of people who had been disregarded by gaming efforts: the elderly, women, and so on. According to Nintendo's CEO Iwata, "Women are the most prized targets but this untapped market spans a vast swath of the population—everybody, actually, bar fast-thumbed teenaged boys."[4] The view was that by marketing to segments of the consumer population currently not reached, Nintendo could create for itself infinite possibilities for profitable growth. Ultimately by taking its product outside the realms of the established demand, Nintendo intended to become its sole competitor. Mr. Iwata insisted that "having a unique product is more important than an attractive price point."[5]

By appealing to "ordinary" consumers, developers of the gaming console were able to simplify its design, focusing less on hyperrealistic graphics and more on artistic elements. Because of the intense competition within the gaming market, gaming systems had become extremely technologically complex. This factor alone was the cause for the large quantity of uncontested consumers who were either unable to learn or uninterested in learning to use such advanced systems for recreational entertainment. By simplifying the design and use of the Wii system, the developers created the perfect entry strategy for their new target market. The success and the challenges associated with this strategy were reflected by two comments that appeared on a blog in response to an article published by *Fortune* on CNNMoney.com in October 2008. One of the bloggers, representative of the hardcore gaming segment identified as "Former Nintendo Fan," commented:

> As a gamer, I have never disliked a console more than the Wii. How it continues to dominate in sales is beyond me when there's very little quality games to play on it. I guess Nostalgia (outdated graphics, simple gameplay etc.) really does sell.[6]

However, in response to this comment, a blogger who identified herself as Cheryl from Pittsburgh, Pennsylvania, and was more consistent with Nintendo's new target market replied:

> See, that's what nobody gets—it's not the gamers that are buying Wii. It's moms, families, grandparents. They're after an interactive game that anyone can figure out in a few minutes, not intricate games with awesome graphics.[7]

Nintendo personnel believed that by creating an innovative product that would appeal to an entirely new demographic and engage new players of video games with its innovative remote controllers, the company could avoid a protracted battle with Sony and Microsoft to win added sales and market share for the Wii. Moreover, Nintendo decided to introduce the Wii with an innovative marketing strategy. The strategy called for using commercials featuring the slogan "Wii would like to play" and exhibiting a varied collection of people as users of the gaming system (grandparents, teens, urban families, etc.).

Nintendo sourced components for the Wii from a number of manufacturers to ensure product quality and to control distribution. Nintendo originally engaged a single manufacturer, Taiwan-based Foxconn Precision Components, which also manufactured the Apple iPhone, Sony's PS3, and personal computers. However, as the company's inability to keep up with demand continued, Nintendo announced in July 2007 that it would diversify its manufacturing base and formed additional partnerships for the manufacturing and supply of key components, such as controller chips, and for assembly of the Wii systems. In the months leading up to the 2008 holiday retail season, Nintendo increased production of the Wii by 50 percent to 2.4 million consoles per month in an attempt to keep up with retailer orders. While these tactics did help increase the supply of Wiis, the systems were still hard to find during the 2008 holiday retail season and into the spring of 2009. Wii's total sales through July 31, 2009, are shown in Exhibit 4.

Exhibit 4

Total Nintendo Wii Unit Sales as of July 31, 2009

REGION	TOTAL UNITS SOLD (IN MILLIONS)	FIRST AVAILABLE
Europe	16.67	December 8, 2006
Japan	8.27	December 2, 2006
America	23.91	November 19, 2006
Other regions	2.75	December 8, 2006
Worldwide	51.60	

Source: www.vgchartz.com (accessed August 3, 2009).

Competition in the Console Segment of the Video Game Industry

Sales of video game consoles, software, and accessories reached a record high of $23.1 billion in 2008, which was 19 percent greater than 2007 industry revenues. Growth in the industry had fluctuated significantly over the past few decades and had been driven by technological advancements and societal trends, among other factors. The industry had also been impacted by the increase in the number of competitors, consolidation, and the continuous development of new products as competitors fought to capture a larger share of the core gamers in the market. Despite the increasing intensity of competition, the video gaming industry as a whole had continued to grow through the end of 2008 in the face of the downturn in the general world economy. However, as the recession lingered into 2009, the video game industry became affected, with industry revenues declining from $1.7 billion recorded in June 2008 to $1.2 billion in June 2009. The quarterly decline in industry revenues was the steepest decline in industry sales since September 2000. Sales of consoles were affected the greatest by the recession, with console sales falling from $617. 3 million in June 2008 to $382.6 million in June 2009.

Since the inception of the video gaming industry, companies producing video gaming consoles had attempted to win market share by developing products that were technologically superior and more powerful than the offerings of rivals. Sixth-generation consoles such as Nintendo's GameCube, Sega's Dreamcast, Sony's PlayStation 2, and Microsoft's Xbox began the century with considerable development in the realm of home video gaming technology. Nintendo became the first to use optical discs rather than game cartridges for gaming storage. Sega's Dreamcast, the first console of the sixth generation, introduced Internet gaming as a standard feature through its built-in modem and a corresponding Web browser. The Dreamcast was also the first home gaming console to fully display in standard definition (SD) resolution. With the PS2, consumers were able to play DVDs through their console, which was also backward-compatible with games made for its predecessor, PlayStation. Microsoft's Xbox continued Dreamcast's idea of online game playing by including a feature called Xbox Live, Microsoft's online gaming community that became a success because of the utilization of PC-style features such as a broadband connection and a hard disk drive available for memory storage, which connected Xbox players all over the world together in one place.

The seventh generation of home video gaming consoles contributed significantly to advancement in video gaming technology. Each new console introduced a new type of breakthrough technology. For example, Microsoft's Xbox 360 and Sony's PS3 offered the first ever high-definition graphics. The Nintendo Wii offered the integration of controllers and motion sensors to create a completely new arena of player control based on the individual player's own movements. Additionally, all three of the seventh-generation consoles employed wireless controllers. With regard to handheld gaming systems, the seventh-generation Nintendo DS perfected the use of Wi-Fi wireless technology. Sony developed the PlayStation Portable (PSP) with great multimedia capabilities, connectivity with the PS3, and other PSP consoles through Internet connectivity.

While overall technology had continued to advance as companies built on one another's progress, the current generation of consoles had leveraged advances in both technology and social trends in an attempt to establish a competitive advantage over rivals. Developers of video gaming consoles looked to changes in social trends in order to better target an appropriate market and capture considerable market share. As the focus on social trends had grown, developers such as Nintendo had shifted their focus to attempting to target *new* customers rather than fighting with competitors over the *old* customers. Competitors were actively seeking to develop new ways of attracting first-time video gaming consumers to their particular product but did not want to forget or neglect their loyal fan base.

When Nintendo released the Wii gaming console on September 14, 2006, the company was already facing significant competition from Microsoft's Xbox 360, which was released on November 22, 2005. Due to its early launch, the Xbox 360 had a one-year lead over both the Nintendo Wii and the Sony PS3; however, because of its new gaming concept, developers at Nintendo did not consider this a major setback. The target market they were aiming to pursue was completely different from that of Sony or Microsoft.

When launched, the Xbox 360 retailed at $299 to $399, PlayStation 3 at $499 to $599, and the Wii at $249. The Wii had generated monthly sales higher than those of competing products across the globe. According to the National Purchase Diary, a leading global market research company, in the first half of 2007, the Nintendo Wii sold more units in the United States than the Xbox 360 and PS3, fellow seventh-generation gaming consoles. This lead was even larger in the Japanese market, where the Wii led in total sales, having outsold both consoles by factors of 2:1 and 6:1 nearly every week from its launch until November 2007.

Over the long term, both Microsoft and Sony had traditionally been operating at a loss in hopes of making significant profit gain in software and game sales, especially when the systems were first launched. For example, it was estimated that PS3 in particular was generating a $250 loss with each unit sold. According to the *Financial Times,* however, the Wii was earning a profit per console sold estimated at around $13 in Japan, $50 in the United States, and $79 in parts of Europe.[8] The differences in gains and loss were attributed to the Wii's low cost of production and the extensive amount of money and resources Nintendo's competitors expended upon development. However, by October 2008, it was estimated that Microsoft had reduced its production costs on some of its Xbox models so that the company was making a profit on some of these models, and that Sony was also taking steps to reduce its production costs.

Another one-up for the Wii—neither Sony nor Microsoft had made any significant developments with regard to their controller, which was one of the main differentiating features of the Wii gaming system. "Microsoft and Sony spend a lot of time developing cutting-edge technology. Nintendo is not a technology company—it is a toy company. It is not interested in bleeding-edge electronics and graphics," said In-Stat video game analyst Brian O'Rourke.[9] Even considering this, comparing the three consoles was very difficult. Both the Xbox 360 and the PS3 were high-definition (HD) consoles with quality graphics and games specifically designed for HD output, while the Wii was an experimental, next-generation technology gaming console. A list of the most important game consoles of each technological generation is shown in Exhibit 5.

Exhibit 5

Evolution of the Home Gaming Console Industry

First generation	Magnavox Odyssey Atari Pong Coleco Telstar
Second generation	Atari 2600 Atari 5200 Coleco Vision
Third generation	Nintendo Entertainment System Atari 7800
Fourth generation	Sega Genesis Super Nintendo Entertainment System System
Fifth generation	Sony PlayStation Sega Saturn Nintendo 64
Sixth generation	Sega Dreamcast Sony PlayStation 2 Nintendo GameCube Microsoft Xbox
Seventh generation	Sony PlayStation 3 Nintendo Wii Microsoft Xbox 360

SonyP layStation 3

Sony's seventh-generation video gaming console was the PlayStation 3. This model followed its similar predecessors—the PlayStation (fifth generation) and the PlayStation 2 (sixth generation). The PS3 separated itself from the previous systems through its unique feature of unified online gaming via the PlayStation Network. Other distinguishing features of the PS3 included connectivity with the PlayStation Portable, the inclusion of a high-definition Blu-ray optical drive, and various multimedia capabilities. Sony justified the PS3's exceptionally high price by pointing out that the PS3 was the only game console including a high-definition Blu-ray drive. Two initial versions of the PS3 were backward-compatible with many of the PlayStation and PS2 games. However, in August 2008, in an effort to reduce production costs, Sony announced that new versions of the console would no longer be backward-compatible with the PlayStation and PlayStation 2 discs, although many of the most popular titles would be available for download at the PlayStation Store.

First released on November 11, 2006, the PlayStation 3 proved relatively unprofitable for Sony despite its sales of 23 million units worldwide as of July 31, 2009. Shortly after its November 2006 launch, the production cost for the PlayStation 3 was said to be as high as $805.85. Even with a launch pricing of $499–$599, the high production costs of the PS3 led to an operating loss of ¥232.3 billion (U.S. $1.97 billion) in the fiscal year ending March 2007. The PS3's outlook with regard to its consumer reception wasn't much better than its financial performance. Initially, the PlayStation 3 received generally critical reviews from customers, with many noting its unreasonably high retail price and the lack of games equivalent in quality to those of its competitors. However, after Sony made several cuts in the retail price and developed a handful of successful games, the console proceeded to receive more positive reviews. However, in early 2009, unit sales for the $130 PS2 were nearly 60 percent as high as PS3 unit sales as many consumers looked for low-priced alternatives to seventh-generation game consoles. At the conclusion of the 2008 holiday retail season, more than 50 million PS2 consoles had been sold in North America and Sony management had commented that the company intended to promote the development of new PS2 games. Sony's PSP had sold nearly 49 million units worldwide by July 31, 2009.

Sony PS3 users with broadband Internet access had free access to the online PlayStation Network. The PlayStation Network provided users with an Internet browser, video and voice chat, and access to the PlayStation Store. The PlayStation Store allowed users to download both free and premium content, including full games, game demos, additional game content, and movies and television shows from major producers such as Sony Pictures, MGM, and Disney. Sony launched PlayStation Home in 2008, which allowed users to join a 3D virtual community in which they could create an avatar that would have its own home space that could be decorated with items that players could either acquire in games or purchase. Users in this virtual world could interact with others in a number of ways, including playing games. Unit sales by geographic region for the PS3 through July 31, 2009, are provided in Exhibit 6.

Exhibit 6

Total Sony PlayStation 3 Unit Sales as of July 31, 2009

REGION	TOTAL UNITS SOLD (IN MILLIONS)	FIRST AVAILABLE
Europe	9.28	March 23, 2007
Japan	3.31	November 11, 2006
America	8.95	November 17, 2006
Other regions	1.46	
Worldwide	23.00	

Source: www.vgchartz.com (accessed August 3, 2009).

MicrosoftX box3 6o

At its launch, Nintendo Wii's other main competitor was Microsoft's Xbox 360. This seventh-generation console was the second system manufactured by Microsoft following its predecessor Xbox (released in 2001). A distinguishing feature of the Xbox 360 was the ability to access its online multiplayer gaming network, Xbox Live. Microsoft's online gaming community became a success because of the utilization of PC-style features such as a broadband connection and a hard drive disk available for memory storage, which connected Xbox players all over the world. Inside, the Xbox 360 used the triple-core Xenon, designed by IBM, as its central processing unit (CPU). However, the Xbox 360 had suffered from a higher than average number of technical issues, which had resulted in Microsoft extending the warranty to three years for "general hardware failures."

When released, the Xbox 360 was available in four different variations: (1) the entry-level option named the Xbox 360 Core, which had since been discontinued and replaced by the Xbox 360 Arcade, which featured a wireless controller, a 256 MB memory unit, a composite AV cable, HDMI 1.2 output, and five Xbox Live Arcade titles; (2) the Xbox 360 Premium, which included all the features of the Arcade as well as a hybrid composite and component cable with optional optical out instead of a composite cable; (3) the Xbox 360 Premium, which also included a detachable 20 GB hard disk drive to store downloaded content; and (4) the Xbox 360 Elite, the most expensive variation of the console, priced at $449.99, which included a 120 GB hard drive and a matte black finish. The Elite retail package also included an HDMI 1.2 cable and a controller and headset that matched the console's black finish.

A key component of Microsoft's strategy involved its Xbox Live service. This service allowed users to access a number of features depending on their choice of the free Silver level of service or the Gold level, which cost approximately $50.00 per year. Services at the Silver level included online voice chat; the opportunity to download new content for video games such as new levels; and access to the Xbox Live Marketplace, which had both free and premium content, including Xbox games, new game demos, and Xbox Live Arcade titles. Users who opted for the Gold level of service could play multiplayer games, had early access to downloadable content, and could use live video chat. In November 2008, Microsoft expanded Xbox Live with the New Xbox Experience, which allowed users to stream programming from Netflix's library of 30,000 movies and TV episodes and added enhanced multiplayer gaming capabilities. In early 2009 Xbox Live had more than 1 million Gold members. The combination of Xbox 360 sales, software sales and royalties, and Xbox Live subscriptions helped Microsoft's entertainment and devices division earn its first ever profit in 2008. The division was expected to report a loss in 2009 as the economy continued to struggle and consumers cut back on discretionary spending. Unit sales by geographic region for the Xbox 360 through July 31, 2009, are shown in Exhibit 7.

Exhibit 7

Total Microsoft Xbox 360 Unit Sales as of July 31, 2009

REGION	TOTAL UNITS SOLD (IN MILLIONS)	FIRST AVAILABLE
Europe	9.78	November 22, 2005
Japan	1.11	December 10, 2005
United States	17.82	November 22, 2005
Other regions	2.64	
Worldwide	31.35	

Source: www.vgchartz.com (accessed August 3, 2009).

Nintendo's Situation in Mid-2009

Nintendo had ended an extraordinary year in 2008 setting new revenue and earnings records and selling more than 31 million Nintendo DS handheld game systems and nearly 26 million Wii consoles during the year. However, with the company's sales of Wii consoles falling from 5.17 million units during the quarter ending June 30, 2008, to 2.23 million during the quarter ending June 30, 2009, and sales of DS systems falling 14 percent during the quarter to 5.97 million units, Nintendo management was forced to evaluate its strategic situation. Upon examining the company's performance that included a 40 percent year-over-year decline in quarterly revenues and a 61 percent year-over-year decline in quarterly profits, management had concluded that the poor quarterly performance was primarily related to the recession impacting many developed countries and its own inability to launch new blockbuster game titles to compete with new games introduced for the Sony PS3 and Microsoft Xbox 360.

Analysts believed that the effect of the recession brought on by rising oil prices and the credit crisis caused by the subprime home mortgage crisis in the U.S. would have a continuing effect on the producers of nonessential goods and services, but nevertheless also believed that Nintendo must continue to expand its customer base and defend its market from its rivals. Both Microsoft and Sony had announced intentions to create a broader variety of ways for users to interact with games on their respective systems and to pursue the casual gamer market. However, analysts who closely monitored the progression of the Wii noted that the only limitations of the system were the limitations of the designer and the user—leading most to believe they considered the possibilities endless. With that in mind, analysts suggested that Nintendo should continue to launch innovative products such as the Wii Fit to add to the company's already expansive repertoire of gaming possibilities with the console and continue to expand the video game market.

Endnotes

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Case 8

Google's Strategy in 2009

JohnE. Gamble
Universityo fSo uthAl abama

The number of people worldwide accessing the Internet to read breaking news, conduct library research, make consumer e-commerce transactions, use Web-based business applications, and perform other online tasks had grown at an astronomic rate since the 1994 introduction of the Netscape Navigator browser. The number of Internet users worldwide had increased from about 360 million in 2000 to nearly 1.6 billion in 2009. North America had the world's highest Internet penetration rate with 74.4 percent of North America's population having Internet access. About 220 million of the 251 million Internet users in North America resided in the United States. Even though only 17.4 percent of Asians had Internet access in 2009, Asia's 657 million Internet users made it the world's largest and fastest growing geographic region for Internet usage.

The growth in the number of Internet users worldwide and in the United States had caused a shift in how advertisers communicated with consumers and had allowed Internet advertising to become the second most common form of advertising used in the United States in 2007. Only newspaper, with 2007 advertising revenues of $48.6 billion, controlled a larger share of United States advertising dollars. Cable television, radio, and network television each accounted for about $20 billion each in advertising revenues during 2007. The prospects for Internet advertisers looked strong in 2009 with Internet advertising expected to grow from $21 billion in 2007 to $36.5 billion in 2011. Search-based ads accounted for the largest portion of Internet advertisements in the United States during 2007—amounting to nearly $9 billion in industry revenues. Video ads shown on YouTube and other Web sites accounted for only $505 million in 2007, but were expected to grow to a $5.8 billion market by 2013. Mobile search was another rapidly growing advertising media format, which was projected to increase from worldwide revenues of $813 million in 2007 to $5 billion by 2013.

Advertisers believed search-based ads were particularly effective because they were highly targeted to what Internet users were immediately searching for. In 2009, Google was the worldwide leader in Internet and mobile search advertising because of consumers' faith in the search engine. Internet users trusted Google's results because its paid search results were not interspersed with other search results and were clearly marked as Sponsor Links. Perhaps Google's most important feature was its capability to retrieve highly relevant results to search queries that was made possible by its innovative text-matching techniques and PageRank technology.

When an Internet user entered a search query at Google.com, from a Google toolbar or deskbar, or requested a search at a Web site that licensed Google's search appliance, the search engine performed a computation of an equation involving 500 million variables and 2 billion terms to generate a list of best-matching search results. The results were generated in a fraction of a second and pulled from an index of 1 trillion Web sites that were constantly downloaded onto Google's PC and server farms located around the world. The reason many Internet users found Google's search results more relevant than results generated by competing search engines was based upon this equation that assessed how well the search terms match and, most importantly, how many other Web sites point to a site. Google cofounder Larry Page suggested Google's technology that counted the number of "votes" for various Web sites that might match search requests was superior to other search technologies because "You're asking the whole Web who's the greatest site to ask about this subject."[1] Internet users' preference for Google's search results produced 2008 revenues of nearly $21.8 billion and profits of more than $4.2 billion. The highly scaleable business model added relatively little additional fixed cost as volume increased, which helped boost the company's cash, cash equivalents, and marketable securities to $15.8 billion at the end of 2008.

With Google controlling the market for search-based ads, much of the company's attention was focused on new initiatives that might allow the company to sustain its extraordinary growth in revenues, earnings, and net cash provided by operations. Google launched its Android operating system for mobile phones in 2008, which would allow wireless phone manufacturers such as LG, HTC, and Nokia to produce Internet-enabled phones boasting features similar to what were available on Apple's iPhone. Widespread use of the Internet-enabled Android phones would not only help Google solidify its 2008 mobile search market share of 63 percent, but would also allow it to increase its share of banner ads and video ads displayed on mobile phones. Perhaps the company's most ambitious strategic initiative in 2009 was its desire to change the market for commonly used business productivity applications such as word processing, spreadsheets, and presentation software from the desktop to the Internet. The company's Google Apps "cloud computing" software would allow corporate software users to access Google's data centers to run software applications and store files that might be needed by other users engaged in collaborative projects. Information technology analysts believed that the market for cloud computing applications could grow to $95 billion by 2013. The company had developed its Chrome operating system and Chrome browser specifically to handle the demands of running cloud applications. Other strategic issues confronting Google's chief managers in 2008 included how to best capitalize on such recent acquisitions as its DoubleClick banner ad management program and YouTube video sharing network and how to increase its share of search-based ads in emerging markets. However, the ongoing recession in the United States and other developed countries might prove to be the greatest obstacle to Google's future growth. The company's revenues during the second quarter of 2009 grew by a meager 3 percent over the second quarter 2008 revenues although its net income grew by 18 percent from the same period in 2008 to reach an impressive $1.48 billion.

Company History

The development of Google's search technology began in January 1996 when Stanford University computer science graduate students Larry Page and Sergey Brin collaborated to develop a new search engine they named BackRub. The new search engine was named BackRub because of its ability to rate Web sites for relevancy by examining the number of back links pointing to the Web site. The approach for assessing the relevancy of Web sites to a particular search query used by other Web sites at the time was based on examining and counting metatags and keywords included on various Web sites. By 1997, the search accuracy of BackRub had allowed it to gain a loyal following among Silicon Valley Internet users. Yahoo! cofounder David Filo was among the converted and in 1998 he convinced Sergey Brin and Larry Page to leave Stanford to focus on making their search technology the backbone of a new Internet company.

BackRub would be renamed Google, which was a play on the word googol—a mathematical term for a number represented by the numeral 1 followed by 100 zeros. Brin and Page's adoption of the new name reflected their mission to organize a seemingly infinite amount of information on the Internet. In August 1998, a Stanford professor arranged for Sergey and Larry to meet at his home with a potential angel investor to demonstrate the Google search engine. The investor, who had been a founder of Sun Microsystems, was immediately impressed with Google's search capabilities, but was too pressed for time to hear much of their informal presentation. The investor stopped the two during the presentation and suggested, "Instead of us discussing all the details, why don't I just write you a check?"[2] The two partners held the investor's $100,000 check made payable to Google Inc. for two weeks while they scrambled to set up a corporation named Google Inc. and open a corporate bank account. The two officers of the freshly incorporated company went on to raise a total of $1 million in venture capital from family, friends, and other angel investors by the end of September 1998.

Even with a cash reserve of $1 million, the two partners ran Google on a shoestring budget with its main servers built by Larry and Sergey from discounted computer components and its four employees operating out of a garage owned by a friend of the founders. By year-end 1998 Google's beta version was handling 10,000 search queries per day and *PC Magazine* had named the company to its list of "Top 100 Web Sites and Search Engines for 1998."

The new company recorded successes at a lightning-fast pace, with the search kernel answering more than 500,000 queries per day and Red Hat agreeing to become the company's first search customer in early 1999. Google attracted an additional $25 million in funding from two leading Silicon Valley venture capital firms by mid-year 1999 to support further growth and enhancements to Google's search technology. The company's innovations in 2000 included wireless search technology, search capabilities in 10 languages, and a Google Toolbar browser plug-in that allowed computer users to search the Internet without first visiting a Google-affiliated Web portal or Google's homepage. Features added through 2004 included Google News, Google Product Search, Google Scholar, and Google Local. The company also expanded its index of Web pages to more than 8 billion and increased its country domains to more than 150 by 2004. Google also further expanded its products for mobile phones with a short message service (SMS) feature that allowed mobile phone users to send a search request to Google as a text message. After submitting the search request to 466453 (google), mobile phone users would receive a text message from Google providing results to the user's query.

TheI nitialP ublicO ffering

Google's April 29, 2004, IPO registration became the most talked-about planned offering involving an Internet company since the dot-com bust of 2000. The registration announced Google's intention to raise as much as $3.6 billion from the issue of 25.7 million shares through an unusual Dutch Auction. Among the 10 key tenants of Google's philosophy presented in Exhibit 1 was "You can make money without doing evil."[3] The choice of a Dutch Auction stemmed from this philosophy since Dutch Auctions allowed potential investors, regardless of size, to place bids for shares. The choice of a Dutch Auction was also favorable to Google since it involved considerably lower investment banking and underwriting fees and little or no commissions for brokers.

At the conclusion of the first day of trading, Google's shares had appreciated by 18 percent to make Brin and Page each worth approximately $3.8 billion. Also, an estimated 900 to 1,000 Google employees were worth at least $1 million, with 600 to 700 holding at least $2 million in Google stock. On average, each of Google's 2,292 staff members held approximately $1.7 million in company stock, excluding the holdings of the top five executives. Stanford University also enjoyed a $179.5 million windfall from its stock holdings granted for its early investment in Brin and Page's search engine. Some of

Exhibit1

The 10 Principles of Google's Corporate Philosophy

1. **Focus on the user and all else will follow.**
From its inception, Google has focused on providing the best user experience possible. While many companies claim to put their customers first, few are able to resist the temptation to make small sacrifices to increase shareholder value. Google has steadfastly refused to make any change that does not offer a benefit to the users who come to the site:
   - The interface is clear and simple.
   - Pages load instantly.
   - Placement in search results is never sold to anyone.
   - Advertising on the site must offer relevant content and not be a distraction.
   By always placing the interests of the user first, Google has built the most loyal audience on the Web. And that growth has come not through TV ad campaigns, but through word of mouth from one satisfied user to another.

2. **It's best to do one thing really, really well.**
Google does search. With one of the world's largest research groups focused exclusively on solving search problems, we know what we do well, and how we could do it better. Through continued iteration on difficult problems, we've been able to solve complex issues and provide continuous improvements to a service already considered the best on the web at making finding information a fast and seamless experience for millions of users. Our dedication to improving search has also allowed us to apply what we've learned to new products, including Gmail, Google Desktop, and Google Maps.

3. **Fast is better than slow.**
Google believes in instant gratification. You want answers and you want them right now. Who are we to argue? Google may be the only company in the world whose stated goal is to have users leave its website as quickly as possible. By fanatically obsessing on shaving every excess bit and byte from our pages and increasing the efficiency of our serving environment, Google has broken its own speed records time and again.

4. **Democracy on the web works.**
Google works because it relies on the millions of individuals posting websites to determine which other sites offer content of value. Instead of relying on a group of editors or solely on the frequency with which certain terms appear, Google ranks every web page using a breakthrough technique called PageRank™. PageRank evaluates all of the sites linking to a web page and assigns them a value, based in part on the sites linking to them. By analyzing the full structure of the web, Google is able to determine which sites have been "voted" the best sources of information by those most interested in the information they offer.

5. **You don't need to be at your desk to need an answer.**
The world is increasingly mobile and unwilling to be constrained to a fixed location. Whether it's through their PDAs, their wireless phones or even their automobiles, people want information to come to them.

6. **You can make money without doing evil.**
Google is a business. The revenue the company generates is derived from offering its search technology to companies and from the sale of advertising displayed on Google and on other sites across the web. However, you may have never seen an ad on Google. That's because Google does not allow ads to be displayed on our results pages unless they're relevant to the results page on which they're shown. So, only certain searches produce sponsored links above or to the right of the results. Google firmly believes that ads can provide useful information if, and only if, they are relevant to what you wish to find.
   Advertising on Google is always clearly identified as a "Sponsored Link." It is a core value for Google that there be no compromising of the integrity of our results. We never manipulate rankings to put our partners higher in our search results. No one can buy better PageRank. Our users trust Google's objectivity and no short-term gain could ever justify breaching that trust.

continued

Exhibit 1 (continued)

7. **There's always more information out there.**
Once Google had indexed more of the HTML pages on the Internet than any other search service, our engineers turned their attention to information that was not as readily accessible. Sometimes it was just a matter of integrating new databases, such as adding a phone number and address lookup and a business directory. Other efforts required a bit more creativity, like adding the ability to search billions of images and a way to view pages that were originally created as PDF files. The popularity of PDF results led us to expand the list of file types searched to include documents produced in a dozen formats such as Microsoft Word, Excel and PowerPoint. For wireless users, Google developed a unique way to translate HTML formatted files into a format that could be read by mobile devices. The list is not likely to end there as Google's researchers continue looking into ways to bring all the world's information to users seeking answers.

8. **The need for information crosses all borders.**
Though Google is headquartered in California, our mission is to facilitate access to information for the entire world, so we have offices around the globe. To that end we maintain dozens of Internet domains and serve more than half of our results to users living outside the United States. Google search results can be restricted to pages written in more than 35 languages according to a user's preference. We also offer a translation feature to make content available to users regardless of their native tongue and for those who prefer not to search in English, Google's interface can be customized into more than 100 languages.

9. **You can be serious without a suit.**
Google's founders have often stated that the company is not serious about anything but search. They built a company around the idea that work should be challenging and the challenge should be fun. To that end, Google's culture is unlike any in corporate America, and it's not because of the ubiquitous lava lamps and large rubber balls, or the fact that the company's chef used to cook for the Grateful Dead. In the same way Google puts users first when it comes to our online service, Google Inc. puts employees first when it comes to daily life in our Googleplex headquarters. There is an emphasis on team achievements and pride in individual accomplishments that contribute to the company's overall success. Ideas are traded, tested and put into practice with an alacrity that can be dizzying. Meetings that would take hours elsewhere are frequently little more than a conversation in line for lunch and few walls separate those who write the code from those who write the checks. This highly communicative environment fosters a productivity and camaraderie fueled by the realization that millions of people rely on Google results. Give the proper tools to a group of people who like to make a difference, and they will.

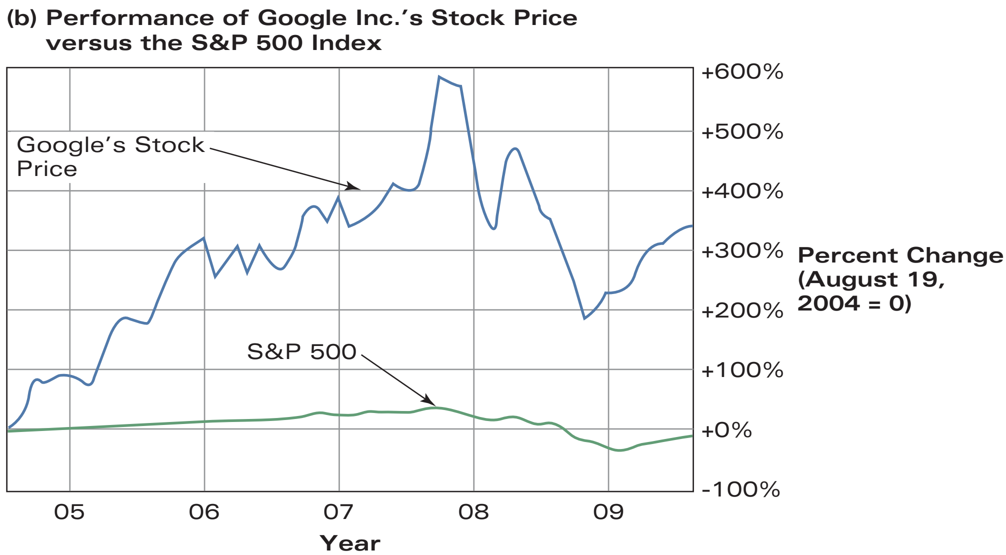
10. **Great just isn't good enough.**
Always deliver more than expected. Google does not accept being the best as an endpoint, but a starting point. Through innovation and iteration, Google takes something that works well and improves upon it in unexpected ways. Google's point of distinction, however, is anticipating needs not yet articulated by our global audience, then meeting them with products and services that set new standards. This constant dissatisfaction with the way things are is ultimately the driving force behind the world's best search engine.

Source: Google.com.

Google's early contractors and consultants also profited handsomely from forgoing fees in return for stock options in the company. One such contractor was Abbe Patterson, who took options for 4,000 shares rather than a $5,000 fee for preparing a PowerPoint presentation and speaking notes for one of Brin and Page's first presentations to venture capitalists. After two splits and four days of trading, her 16,000 shares were worth $1.7 million.[4] The company executed a second public offering of 14,159,265 shares of common stock in September 2005. The number of shares issued represented the first eight digits to the right of the decimal point for the value pi. The issue added more than $4 billion to Google's liquid assets. Exhibit 2 tracks the performance of Google's common shares between August 19, 2004, and November 2008.

Exhibit2

Performance of Google Inc.'s Stock Price, August 19, 2004, to August 2009



GoogleF eature Additionsbet ween 2005 and 2009

Google used its vast cash reserves to make strategic acquisitions that might lead to the development of new Internet applications offering advertising opportunities. Google Earth was launched in 2005 after the company acquired Keyhole, a digital mapping company in 2004. Google Earth and its companion software, Google Maps, allowed Internet users to search and view satellite images of any location in the world. The feature could give users close-up aerial views of the Eiffel Tower, the Taj Mahal, the Grand Canyon, or their own residence. The images were not real time images, but were taken by commercial satellites within the past few years. The feature was enhanced with street view images that allowed users to upload pictures linked to any location in the world. Other search features added to Google between 2005 and 2008 that users found particularly useful included Book Search and the expansion of Google News to include archived news articles dating to 1900.

Google also expanded its Web site features beyond search functionality to include its Gmail e-mail software, a Web-based calendar, Web-based document and spreadsheet applications, Picasa Web photo albums, and a translation feature that accommodated 28 languages. Google Talk was a Google feature launched in 2005 that provided instant messaging services to Google users, along with free PC to PC local and long distance voice calls. The company also released services for mobile phone uses such as Mobile Web Search, Blogger Mobile, Gmail, Google News, and Maps for Mobile.

The company utilized some proceeds of its IPO to make acquisitions that would expand its business model. The 2006 acquisition of dMarc allowed Google advertisers to bid on radio advertising spots as well as seach-based ads. Google's Web-based document and spreadsheet software resulted from its acquisition of Writely in 2006. Google was able to attract millions of new users through its acquisition of YouTube in 2006 and its 2008 acquisition of DoubleClick allowed the company to generate advertising revenues through banner ad and in-stream video advertising management services. A complete list of Google services and tools for computers and mobile phones in 2009 is presented in Exhibit 3.

Google'sB usiness Model

Google's business model had evolved since the company's inception to include revenue beyond licensing fees charged to corporations needing search capabilities on company intranets or Web sites. The 2000 development of keyword-targeted advertising expanded its business model to include revenues from the placement of highly targeted text-only sponsor ads adjacent to its search results. Google

Exhibit 3

List of Google Services and Tools in 2009

Search Features

Alerts
Get email updates on the topics of your choice

Blog Search
Find blogs on your favorite topics

Book Search
Search the full text of books

Checkout
Complete online purchases more quickly and securely

Google Chrome
A browser built for speed, stability, and security

Desktop
Search and personalize your computer

Earth
Explore the world from your computer

Finance
Business info, news, and interactive charts

GOOG-411
Find and connect with businesses from your phone, for free

Google Health
Organize your medical records online

iGoogle
Add news, games and more to the Google homepage

Images
Search for images on the web

Maps
View maps and directions

News - now with archive search
Search thousands of news stories

Notebook
Clip and collect information as you surf the web

Patent Search
Search the full text of U.S. Patents

Product Search
Search for stuff to buy

Exhibit 3 (continued)

Scholar
Search scholarly papers

Special Searches
Search within specific topics

Toolbar
Add a search box to your browser

Video
Search for videos on Google Video and YouTube

Web Search
Search over billions of web pages

Web Search Features
Find movies, music, stocks, books, and more

Google Tools and Web Applications

Blogger
Share your life online with a blog—it's fast, easy, and free

Calendar
Organize your schedule and share events with friends

Docs
Create and share your online documents, presentations, and spreadsheets

Gmail
Fast, searchable email with less spam

Groups
Create mailing lists and discussion groups

Knol
Share what you know

Orkut
Meet new people and stay in touch with friends

Picasa
Find, edit and share your photos

Reader
Get all your blogs and news feeds fast

Sites
Create websites and secure group wikis

SketchUp
Build 3D models quickly and easily

Exhibit 3 (continued)

Talk
IM and call your friends through your computer

Translate
View web pages in other languages

YouTube
Watch, upload, and share videos

Google Mobile Applications

Maps for mobile
View maps and get directions on your phone

Mobile
Use Google on your mobile phone

SMS
Use text messaging for quick info

Search
Search Google.com on your mobile phone

Source: Google.com

was able to target its ads to specific users based upon the user's browsing history. The addition of advertising-based revenue allowed Google to increase annual revenues from \$220,000 in 1999 to more than \$86 million in 2001.

Beginning in 2005, Google charged fees to advertisers who were successful bidders for magazine, newspaper, radio, and television ads placed with its 650-plus traditional media partners. However, Google abandoned its auctioning model for radio advertising in early 2009 and divested its print ad auctioning system in August 2009. The company's 2006 acquisition of YouTube also allowed it to receive advertising revenues for ads displayed during Internet videos. The company's 2008 launch of Google Checkout allowed it to receive a fee of as much as 2 percent of the transaction amount for purchases made at participating e-retailer sites. A summary of Google's financial performance between 2001 and 2008 is presented in Exhibit4 . The company's balance sheets for 2007 and 2008 are presented in Exhibit 5.

Exhibit 4

Financial Summary for Google, Inc., 2001–2008 (in thousands, except per share amounts)

	2008	2007	2006	2005	2004	2003	2002	2001
Revenues	$21,795,550	$16,593,986	$10,604,917	$6,138,560	$3,189,223	$1,465,934	$ 439,508	$86,426
Costs and expenses:								
Cost of revenues	8,621,506	6,649,085	4,225,027	2,577,088	1,457,653	625,854	131,510	14,228
Research and development	2,793,192	2,119,985	1,228,589	599,510	225,632	91,228	31,748	16,500
Sales and marketing	1,946,244	1,461,266	849,518	468,152	246,300	120,328	43,849	20,076
General and administrative	1,802,639	1,279,250	75,787	386,532	188,151	286,060	45,935	24,658
Contribution to Google Foundation	—	—	—	90,000	—	—	—	—
Nonrecurring portion of settlement of disputes with Yahoo!	—	—	—	—	201,000	—	—	—
Total costs and expenses	15,163,581	11,509,586	7,054,921	4,121,282	2,549,031	1,123,470	253,042	75,462
Income (loss) from operations	6,631,969	5,084,400	3,549,996	2,017,278	640,192	342,464	186,466	10,964
Impairment of equity investments	(1,094,757)	—	—	—	—	—	—	—
Interest income (expense) and other, net	316,384	589,580	461,044	124,399	10,042	4,190	(1,551)	(896)
Income (loss) before income taxes	5,853,596	5,673,980	4,011,040	2,141,677	650,234	346,654	184,915	10,068
Provision for income taxes	1,626,738	1,470,260	933,594	676,280	251,115	241,006	85,259	3,083
Net income (loss)	$ 4,226,858	$ 4,203,720	$ 3,077,446	$1,465,397	$ 399,119	$ 105,648	$ 99,656	$ 6,985
Net income (loss) per share:								
Basic	$ 13.46	$ 13.53	$ 10.21	$ 5.31	$ 2.07	$ 0.77	$ 0.86	$ 0.07
Diluted	$ 13.31	$ 13.29	$ 9.94	$ 5.02	$ 1.46	$ 0.41	$ 0.45	$ 0.04
Number of shares used in per share calculations:								
Basic	314,031	310,806	301,403	275,844	193,176	137,697	115,242	94,523
Diluted	317,570	316,210	309,548	291,874	272,781	256,638	220,633	186,776
Net cash provided by operating activities	$ 7,852,857	$ 5,775,410	$ 3,580,508	$2,459,422	$ 977,044	$ 395,445	$155,265	N/A
Net proceeds from public offerings	—	—	2,063,549	4,287,229	1,161,466	—	—	—
Cash, cash equivalents, and marketable securities	15,845,771	14,218,613	11,243,914	8,034,247	2,132,297	334,718	146,331	N/A
Total assets	31,767,575	25,335,806	18,473,351	10,271,813	3,313,351	871,458	286,892	N/A
Total long-term liabilities	1,226,623	610,525	128,924	107,472	43,927	33,365	N/A	N/A
Total stockholders' equity	28,238,862	22,689,679	17,039,840	9,418,957	2,929,056	588,770	173,953	N/A

Note: N/A = not available
Source: Google Inc. Form S-1 filed April 29, 2004; Google, Inc. 2008 10-K.

Exhibit5

Google, Inc.'s Balance Sheets, 2007–2008 (in thousands, except per share amounts)

AS OF DECEMBER 31,	2008	2007
Assets		
Current assets:		
Cash and cash equivalents	$ 8,656,672	$ 6,081,593
Marketable securities	7,189,099	8,137,020
Accounts receivable, net of allowance of $16,914 and $32,887	2,642,192	2,162,521
Deferred income taxes, net	286,105	68,538
Income taxes receivable	—	145,253
Prepaid revenue share, expenses and other assets	1,404,114	694,213
Total current assets	20,178,182	17,289,138
Prepaid revenue share, expenses and other assets, non-current	433,846	168,530
Deferred income taxes, net, non-current	—	33,219
Non-marketable equity securities	85,160	1,059,694
Property and equipment, net	5,233,843	4,039,261
Intangible assets, net	996,690	446,596
Goodwill	4,839,854	2,299,368
Total assets	$31,767,575	$25,335,806
Liabilities and Stockholders' Equity		
Current liabilities:		
Accounts payable	$ 178,004	$ 282,106
Accrued compensation and benefits	811,643	588,390
Accrued expenses and other current liabilities	480,263	465,032
Accrued revenue share	532,547	522,001
Deferred revenue	218,084	178,073
Income taxes payable, net	81,549	—
Total current liabilities	2,302,090	2,035,602
Deferred revenue, long-term	29,818	30,249
Income taxes payable, long-term	890,115	478,372
Deferred income taxes, net, non-current	12,515	—
Other long-term liabilities	294,175	101,904
Commitments and contingencies		
Stockholders' equity:		
Convertible preferred stock, $0.001 par value, 100,000 shares authorized; no shares issued and outstanding	—	—
Class A and Class B common stock, $0.001 par value per share: 9,000,000 shares authorized; 308,997 (Class A 227,670, Class B 81,327) and par value of $309 (Class A $228, Class B $81) and 312,917 (Class A 236,097, Class B 76,820) and par value of $313 (Class A $236, Class B $77) shares issued and outstanding, excluding 1,296 (Class A 1,045 Class B 251) and 361 (Class A 336, Class B 25) shares subject to repurchase (see Note 11) at December 31, 2006 and 2007	315	313
Additional paid-in capital	14,450,338	13,241,221
Accumulated other comprehensive income	226,579	113,373
Retained earnings	13,561,630	9,334,772
Total stockholders' equity	28,238,862	22,689,679
Total liabilities and stockholders' equity	$31,767,575	$25,335,806

Source: Google, Inc., 2008 10-K.

GoogleS earch Appliance

Google's search technology could be integrated into a third party's Web site or intranet if search functionality was important to the customer. Google's Site Search allowed enterprises ranging from small businesses to public companies to license Google's search appliance for use on their Web sites for as little as $100 per year. The Google Search Appliance was designed for use on corporate intranets to allow employees to search company documents. The Search Appliance included a variety of security features to ensure that only employees with proper authority were able to view restricted documents. The Google Mini Search Appliance was designed for small businesses with 50,000 to 300,000 documents stored on local PCs and servers. The Google Mini hardware and software package could be licensed online at www.google.com/enterprise/mini at prices ranging from $2,990 to $9,900, depending on document count capability. Google's more robust search appliance had a document count capability of up to 30 million documents and was designed for mid-sized to global businesses. Licensing fees for the Google Search appliance ranged from $30,000 to $600,000, depending on document count capability.

AdWords

Google AdWords allowed advertisers either independently through Google's automated tools or with the assistance of Google's marketing teams to create text-based ads that would appear alongside Google search results. AdWords users could evaluate the effectiveness of their advertising expenditures with Google through the use of performance reports that tracked the effectiveness of each ad. Google also offered a keyword targeting program that suggested synonyms for keywords entered by advertisers, a traffic estimator that helped potential advertiser anticipate charges, and multiple payment options that included charges to credit cards, debit cards, and monthly invoicing.

Larger advertisers were offered additional services to help run large, dynamic advertising campaigns. Such assistance included the availability of specialists with expertise in various industries to offer suggestions for targeting potential customers and identifying relevant keywords. Google's advertising specialists also helped develop ads for customers that would increase click-through rates and purchase rates. Google also offered its large advertising customers bulk posting services that helped launch and manage campaigns including ads using hundreds or thousands of keywords.

Google's search-based ads were priced using an auction system that allowed advertisers to bid on keywords that would describe their product or service. Bids could be made on a cost-per-impression (CPI) or cost-per-click (CPC) basis. Most Google advertisers placed bids based upon CPC frequency rather than how many times an ad was displayed by Google. Google's auction pricing model assigned a Quality Score to each bidder that was determined by the advertiser's past keyword click-through rate and the relevance of the ad text. Advertisers with higher Quality Scores were offered lower minimum bids than advertisers with poor quality scores.

Google allowed users to pay a CPC rate lower than their bid price if their bid was considerably more than the next highest bid. For example, an advertiser who bid $0.75 per click for a particular keyword would only be charged $0.51 per click if the next highest bid was only $0.50. The AdWords discounter ensured advertisers paid only 1 cent more than the next highest bid, regardless of the actual amount of theirb id.

AdSense

Google's AdSense program allowed Web publishers to share in the advertising revenues generated by Google's text ads. The AdSense program served content-relevant Google text ads to pages on Google Network Web sites. For example, an Internet user reading an article about the 2008 global economic slowdown at Reuters.

com would see Google text ads by investment magazines and companies specializing in home business opportunities. Google Network members shared in the advertising revenue whenever a site visitor clicked on a Google ad displayed on their sites. The 1 million-plus Google Network members did not pay a fee to participate in the program and received about 60 percent of advertising dollars generated from the ads. Google's AdSense program also allowed mobile phone operators to share in Google revenues if text and image ads were displayed on mobile handsets. Also, owners of dormant domain names and news feeds services could also participate in the AdSense program. The breakdown of Google's revenues by source for 2003 through 2008 is presented in Exhibit 6.

Google's search-based ads could be delivered to Internet users in 41 different languages. In 2008, more than 50 percent of the company's revenues and traffic were generated from outside the United States. Growth in Internet use in rapidly emerging markets such as Russia, India, and China had allowed a larger percentage of Google's revenues to come from advertisers outside the United States. Between 2006 and 2008, Google's advertising revenues in the United States grew by 33 percent annually, while advertising revenues in the United Kingdom grew by 38 percent annually and rest of world revenues grew by 65 percent annually. A breakdown of Google's revenues and long-lived assets by geographic region for 2006 through 2008 is presented in Exhibit 7.

Google's Strategy and Competitive Position in 2009

Google'sS trategies to Dominate Internet Advertising

Google's multiple acquisitions since its 2004 IPO and the focus of its research and development activities were directed at increasing its dominance in Internet advertising. The addition of Google Maps, local search, airline travel information, weather, Book Search, Gmail, Blogger, and other features increased traffic to Google sites and gave the company more opportunities to serve ads to Internet users. Also, the acquisition of Double Click in 2008 allowed Google to diversify its Internet advertising beyond search ads to include banner ads. However, not all of Google's acquisitions and innovations had resulted in a meaningful contribution to the company's revenues. Even though more than 5 billion videos were watched on YouTube each month, the online video site recorded revenues of less than $200 million in 2007. Also, the company's internally developed social networking site, orkut, had failed to match the success of competing social networking sites, facebook.com or myspace.com.

Exhibit6

Google's Revenues by Source, 2003–2008 (in thousands)

	2008	2007	2006	2005	2004	2003
Advertising revenues:						
Google web sites	$14,413,826	$10,624,705	$6,332,797	$3,377,060	$1,589,032	$792,063
Google Network web sites	6,714,688	5,787,938	4,159,831	2,687,942	1,554,256	628,600
Total advertising revenues	21,128,514	16,412,643	10,492,628	6,065,002	3,143,288	1,420,663
Licensing and other revenues	667,036	181,343	112,289	73,558	45,935	45,271
Net revenues	$21,795,550	$16,593,986	$10,604,917	$6,138,560	$3,189,223	$1,465,934

Source: Google Inc., Form S-1, filed April 29, 2004; Google 2008 10-K.

Exhibit7

Google's Revenues and Long-Lived Assets by Geographic Region, 2006–2008 (inthous ands)

	YEAR ENDED DECEMBER 31,		
	2008	2007	2006
Revenues:			
United States	$10,635,553	$ 8,698,021	$ 6,030,140
United Kingdom	3,038,488	2,530,916	1,603,842
Rest of the world	8,121,509	5,365,049	2,970,935
Total revenues	$21,795,550	$16,593,986	$10,604,917
	AS OF DECEMBER 31,		
	2008	2007	2006
Long-lived assets:			
United States	$ 9,782,825	$7,334,877	$5,070,694
Rest of the world	1,806,568	711,791	362,810
Total long-lived assets	$11,589,393	$8,046,668	$5,433,504

Source: Google, Inc., 2008 10-K.

Google's strategy to dominate search-based advertising on mobile devices had been very successful. In 2008, Google accounted for 63 percent of searches performed on Internet-enabled phones. The company's introduction of its Android operating system for mobile phones was expected to allow it to increase its share of mobile searches and expand the market for other types of Internet ads delivered on mobile devices. Android was not a phone, but an operating system that Google made available to any phone manufacturer wishing to market mobile devices with Internet capability. Android's core applications included Wi-Fi capability, e-mail, a Web-based calendar, Google Earth maps, a browser, and GPS. T-Mobile was the first wireless provider to market an Android phone. Its $179 G1 was launched in September 2008 and included essentially the same features found on the more expensive Apple iPhone. Reviews comparing the G1 to the iPhone found that the major advantage of the G1 was that its QWERTY keyboard was preferred by many users over the iPhone's virtual keyboard that required users to type on a video image of a keyboard. The group of reviewers commented that the overall thicker design of the G1 might not be as appealing as the iPhone design for some mobile phone users. Nokia, LG, and HTC planned to launch Android phones in 2009.

Google's Strategic Offensive to Control the Desktop

Google's chief managers believed that, in the very near future, most computer software programs used by businesses would move from local hard drives or intranets to the Internet. Many information technology analysts agreed that "cloud computing" would become a common software platform and could grow to a $95 billion market by 2013. Moving software applications to "the cloud" offered many possible benefits to corporate users including lower software acquisition costs, lower computing support costs, and easier collaboration among employees in different locations. The beta version of Google Apps was launched in 2006 as a free word processing and spreadsheet package for individuals, but was relaunched in 2008 as a competing product to Microsoft Office. Google Apps was hosted on computers in Google's data centers and included Gmail, a calendar, instant messaging, word processing, spreadsheets, presentation software, and file storage space. Google Apps could be licensed by corporate customers at $50 per user per year. The licensing fee for the Microsoft Office and Outlook package was typically $350 per user per year.

Google's Chrome browser, which was launched in September 2008, and Chrome operating system (OS) launched in July 2009 were developed specifically to accommodate cloud computing applications. The bare-bones Chrome browser was built on a multiprocessor design that would allow users to operate spreadsheets, word processing, video editing, and other applications on separate tabs that could be run simultaneously. Each tab operated independently so that if one tab crashed, other applications running from Google's data centers were not affected. The Chrome browser also provided Google with a defense against moves by Microsoft to make it more difficult for Google to deliver relevant search-based ads to Internet users. Microsoft's Internet Explorer 8 allowed users to hide their Internet address and viewing history, which prevented Google from collecting user specific information needed for ad targeting. Mozilla's Firefox browser employed a similar feature that prevented third parties from tracking a user's viewing habits. In 2008, Microsoft Internet Explorer and Mozilla Firefox held browser market shares of 72 percent and 20 percent, respectively. As of late 2008, Google's revenues related to the sale of Google Apps to corporate customers stood at just $4 million. The clean running Chrome OS was an open source operating system specifically designed as a platform for cloud computing applications. Microsoft Office's fiscal 2008 sales of approximately $17 billion gave Microsoft a 98 percent share of the market for office productivitys oftware.

Google's Internet Rivals

Google's ability to sustain its competitive advantage among search companies was a function of its ability to maintain strong relationships with Internet users, advertisers, and Web sites. In 2009, Internet users went to Google to search for information more often than any other site with search capabilities. Google management believed its primary competitors to be Microsoft and Yahoo!. A comparison of the percentage of Internet searches among Web sites offering search capabilities in July 2006 and June 2009 is shown below:

	PERCENT OF SEARCHES	
SEARCH ENTITY	JULY 2006	JUNE 2009
Google Sites	43.7%	65.0%
Yahoo! Sites	28.8	19.6
Microsoft Sites	12.8	8.4
Ask.com	5.4	3.9
AOL	5.9	3.1
Others	3.4	n.m.
Total	100.0%	100.0%

n.m: Not material.

Source: ComScore.com.

YAHOO! Yahoo! was founded in 1994 and was the second leading Internet destination worldwide in 2008 with 142 million unique visitors each month. Almost any information available on the Internet could be accessed through Yahoo!'s Web portal. Visitors could access content categorized by Yahoo or set up an account with Yahoo! to maintain a personal calendar and e-mail account, check the latest news, check local weather, obtain maps, check TV listings, watch a movie trailer, track a stock portfolio, maintain a golf handicap, keep an online photo album, or search personal ads or job listings.

Yahoo! also hosted Web sites for small businesses and Internet retailers and had entered into strategic partnerships with 20 mobile phone operators in the United States and Europe to provide mobile search and display ads to their customers. By 2008, Yahoo! accounted for 35 percent of searches performed on mobile phones. Yahoo!'s broad range of services allowed it to generate revenues from numerous sources—it received fees for banner ads displayed at Yahoo.com, Yahoo! Messenger, Yahoo! Mail, Flickr, or mobile phone customers;

it received listing fees at Yahoo! Autos, Cars.com, and Yahoo! Real Estate; it received revenues from paid search results at Yahoo! Search; it shared in travel agency booking fees made at Yahoo! Travel; and it received subscription fees from its registered users at Rivals.com, Yahoo! Games, Yahoo! Music, and Yahoo! Personals. In 2007, Yahoo! had entered into a strategic alliance with Intel and had executed the acquisition of Right Media to expand its business model beyond Internet advertising and subscription fees charged to Internet users. Its alliance with Intel involved the development of a set-top box that would provide an interactive experience for television viewers. Under the terms of the agreement, Intel would develop the system hardware, while Yahoo! would develop widget applications that would allow television viewers to connect to the Internet to keep track of such information as sports scores, breaking news, or watch an item listed on an eBay auction. Its Right Media acquisition allowed advertisers to bid for ads offered by Yahoo!'s partner newspapers and magazines.

Yahoo!'s relationship with Google dated to 2000 and, since that time, had oscillated between cooperative and adversarial. Yahoo! was among Google's earliest customers for its search appliance, but Yahoo! began to distance itself from Google in 2002 when it began acquiring companies with developed search technologies. Yahoo! replaced Google with its own search capabilities in February 2004. Yahoo! later levied a patent infringement charge against Google that resulted in a settlement that gave Google ownership of the technology rights in return for 2.7 million shares of Google stock. Yahoo! attempted to renew its relationship with Google in 2008 in hopes of reversing a decline in profitability and liquidity that began in 2006. After averting a hostile takeover by Microsoft in June 2008, Yahoo! reached an agreement with Google that would allow Yahoo! to host Google search ads. The partnership would provide Yahoo! with an estimated $800 million in additional revenues annually, most of which would go directly to its bottom line. However, Google withdrew from the agreement in November 2008 after receiving notification from the United States Justice Department that the alliance would possibly violate antitrust statutes. Shortly after being notified that Google was withdrawing from the deal, Yahoo!'s chief managers told business reporters that the company was "disappointed that Google has elected to withdraw from the agreement rather than defend it in court."[5] In July 2009, Microsoft and Yahoo! finally came to an agreement that would make Microsoft Bing Yahoo!'s imbedded search engine for a period of 10 years. A summary of Yahoo!'s financial performance between 2003 and 2008 is presented in Exhibit 8.

Exhibit8

Financial Summary for Yahoo!, Inc., 2003–2008 (in thousands)

	2008	2007	2006	2005	2004	2003
Revenues	$7,208,502	$6,969,274	$6,425,679	$5,257,668	$3,574,517	$1,625,097
Income from operations	12,963	695,413	940,966	1,107,725	688,581	295,666
Net income	424,298	660,000	751,391	1,896,230	839,553	237,879
	2008	**2007**	**2006**	**2005**	**2004**	**2003**
Cash and cash equivalents	$2,292,296	$1,513,930	$1,569,871	$1,429,693	$ 823,723	$ 415,892
Marketable debt securities	1,229,677	849,542	1,967,414	2,570,155	2,918,539	2,150,323
Working capital	3,040,483	937,274	2,276,148	2,245,481	2,909,768	1,013,913
Total assets	13,689,848	12,229,741	11,513,608	10,831,834	9,178,201	5,931,654
Long-term liabilities	715,872	384,208	870,948	1,061,367	851,782	822,890
Total stockholders' equity	11,250,942	9,532,831	9,160,610	8,566,415	7,101,446	4,363,490

Source: Yahoo, Inc., 2008 10-K.

MICROSOFT ONLINE SERVICES Microsoft Corporation recorded fiscal 2008 revenues and net income of approximately $60.4 billion and $17.7 billion, respectively, through the sales of computer software, consulting services, video game hardware, and online services. Windows Vista and Microsoft Office 2007 accounted for more than one-half of the company's 2008 revenues and nearly all of its operating profit. The company's online services business recorded sales of $3.2 billion and an operating loss of $1.2 billion during fiscal 2008. Microsoft's online services business generated revenues from banner ads displayed at the company's MSN Web portal and its affiliated Web sites, search-based ads displayed with Live Search results, and subscription fees from its MSN Dial-up service. A financial summary for Microsoft Corporation and its Online Services Division is provided in Exhibit 9.

Microsoft's Live Search was launched in November 2004 to compete directly with Google and slow whatever intentions it might have to threaten Microsoft in its core operating system and productivity software businesses. Microsoft's concern with threats posed by Google arose shortly after its IPO when Bill Gates noticed that many of the Google job postings on its site were nearly identical to Microsoft job specifications. Recognizing the position announcements had more to do with operating-system design than search, Gates e-mailed key Microsoft executives warning, "We have to watch these guys. It looks like they are building something to compete with us."[6] Gates later commented that Google was "more like us than anyone else we have ever competed with."[7]

Gates speculated that Google's long-term strategy involved the development of Web-based software applications comparable to Word, Excel, PowerPoint, and other Microsoft products. Microsoft's strategy to compete with Google was keyed to making Live Search more effective than Google at providing highly relevant search results. Microsoft believed that any conversion of Google users to Live Search would reduce the number of PC users who might ultimately adopt Google's Web-based word processing, spreadsheet, and presentation software

Exhibit9

Financial Summary for Microsoft Corporation and Microsoft's Online Services Business Unit,2006–2008(inmill ions)

FINANCIAL SUMMARY FOR MICROSOFT CORPORATION

FISCAL YEAR ENDED JUNE 30,	2008	2007	2006
Revenue	$60,420	$51,122	$44,282
Operating income	22,492	18,524	16,472
Net income	17,681	14,065	12,599
Cash, cash equivalents, and short-term investments	$23,662	$23,411	$34,161
Total assets	72,793	63,171	69,597
Long-term obligations	6,621	8,320	7,051
Stockholders' equity	36,286	31,097	40,104

FINANCIAL SUMMARY FOR MICROSOFT'S ONLINE SERVICES BUSINESS UNIT

	2008	2007	2006
Revenue	$ 3,214	$ 2,441	$ 2,296
Operating income (loss)	(1,233)	(617)	5

Source: Microsoft Corporation 2008 Annual Report.

packages. In 2008, Microsoft paid more than $100 million to acquire Powerset, which was the developer of a semantic search engine. Semantic search technology offered the opportunity to surpass the relevancy of Google's search results since semantic search evaluated the meaning of a word or phrase and considered its context when returning search results. Even though semantic search had the capability to answer questions stated in common language, semantic search processing time took several seconds to return results. The amount of time necessary to conduct a search had caused Microsoft to limit Powerset's search index to only articles listed in Wikipedia. Microsoft's developers were focused on increasing the speed of its semantic search capabilities so that its search index could be expanded to a greater number of Internet pages. The company's developers also incorporated some of Powerset's capabilities into its latest generation search engine, Bing, which was launched in June 2009.

Microsoft's search agreement with Yahoo! was engineered to allow the company to increase its Internet search market share and achieve advertising scale necessary to make its online services business profitable. The addition of Yahoo!'s 142 million unique monthly users was expected to double exposure for Microsoft's banner ads to 240 million unique monthly users. Banner ads comprised the bulk of Microsoft's online advertising revenues since its Live Search engine accounted for less than 15 percent of online searches in 2008. Microsoft also established a $500 million agreement with Viacom in 2008 that would place its banner ads on such Viacom Web sites as MTV.com, Nickelodeon.com, BET.com, CMT.com, Rhapsody, and Paramount.com. Even though the $7 billion market for display ads was only about one-third the size of the search ad market in 2008, the advertising spending on banner ads was expected to double by 2012 to reach $15 billion.

Microsoft was also moving forward with its own approach to cloud computing. The company's 2008 launch of Windows Live allowed Internet users to store files online at its password protected SkyDrive site. SkyDrive's online file storage allowed users to access and edit files from multiple locations, share files with co-workers who might need editing privileges, or make files available in a public folder for wide distribution. Azure was Microsoft's most ambitious cloud computing initiative in 2008 and was intended to allow businesses to reduce computing costs by allowing Microsoft to host its operating programs and data files. In addition to reducing capital expenditures for software upgrades and added server capacity, Azure's offsite hosting provided data security in the event of natural disasters such as fires or hurricanes.

Google's Performance in 2009

During its second quarter of fiscal 2009, Google had been able to achieve year-over-year revenue growth of 3 percent, while most companies in almost every industry had experienced sales declines of 25 percent or more as the U.S. recession reached historic levels. As of July 2009, the U.S. Gross Domestic Product (GDP) had fallen by a greater percentage and had declined for more consecutive quarters than in any other economic downturn since the Great Depression. So far, it appeared that Google's business model and strategy had insulated it from the effects of the recession, but companies that had not fared as well during the recession might begin looking more closely at cutting such discretionary expenses as advertising. While Google's chief managers acknowledged the continuing macroeconomic downturn, CEO Eric Schmidt believed the company was poised for growth and would "remain focused on investing in technical innovation to drive growth in our core and new businesses."[8]

The company's strategic priorities were focused on expanding its applications for mobile phone users with the launch of Android and pushing forward with its plan to become the dominant provider of cloud computing solutions. Some analysts preferred that Google focus on activities related to its core business such as developing semantic search capabilities for its Google search appliance.

Some analysts also pointed to the company's weakness in China, where it was a distant number two to local search-based ad provider Baidu. In 2008, 63 percent of Internet searches in China were performed by Baidu, while Google held a 26 percent share of searches in that country. China's nearly 350 million Internet users were the most for any country and made China one of the world's fastest growing markets for search-based advertising in 2009.

Endnotes

[1] As quoted in "High-Tech Search Engine Google Won't Talk about Business Plan," *The Wall Street Journal Online,* June 14, 1999.

[2] As quoted in Google's Corporate Information, www.google.com/corporate/history.html.

[3] As listed under "Our Philosophy," Google Corporate Information, www.google.com/corporate/tenthings.html.

[4] As reported in "For Some Who Passed on Google Long Ago, Wistful Thinking," *The Wall Street Journal Online,* August 23, 2004.

[5] As quoted in "With Google Gone, Will Microsoft Come Back to Yahoo?" *Fortune,* November 5, 2008.

[6] As quoted in "Gates vs. Google," *Fortune,* April 18, 2005.

[7] Ibid.

[8] As quoted in "Google Announces Second Quarter 2009 Results," *Google Inc. Press Release,* July 16, 2009.

Case 9

SkyWest, Inc., and the Regional Airline Industry in 2009

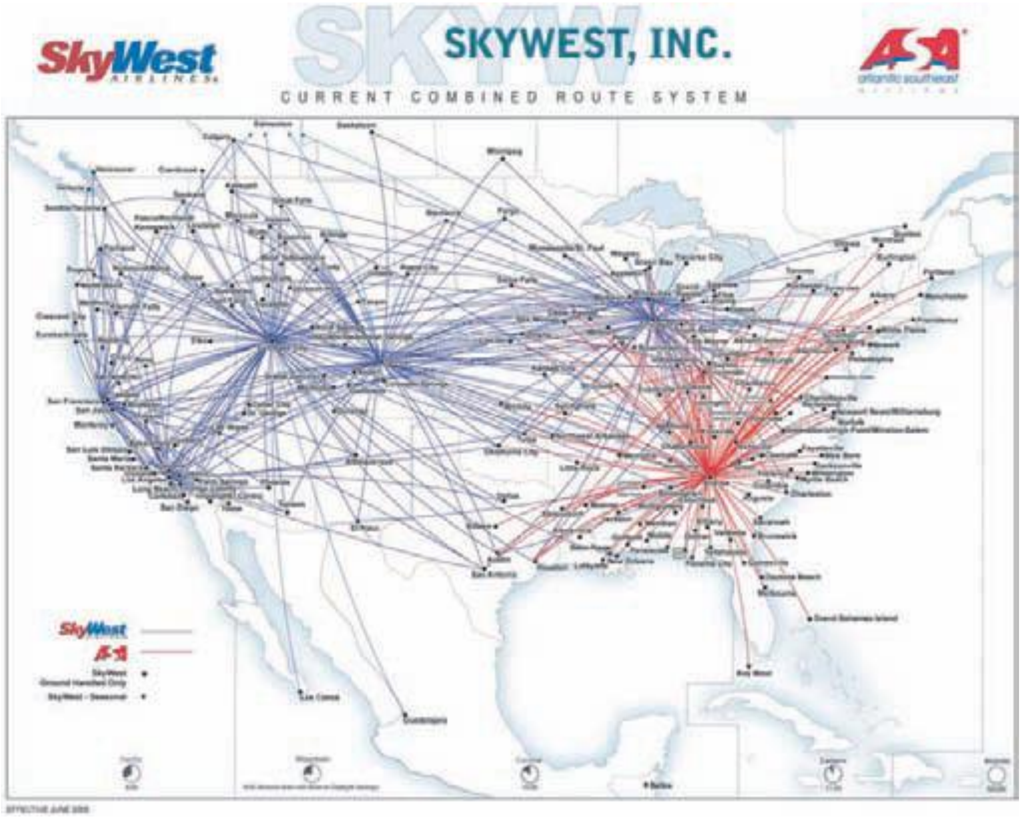
Annette Lohman
California State University, Long Beach

At the end of June 2009, SkyWest, Inc., the parent holding company of SkyWest Airlines and Atlantic Southeast Airlines (ASA), was the largest independently owned regional airline company in the regional airline subgroup of the airline industry. Its two wholly owned regional airlines' combined operations offered service through approximately 2,400 departures to 208 cities in the United States, Canada, Mexico, and the Caribbean.[1] SkyWest, Inc., and its subsidiary, SkyWest Airlines, had been the darling of airline industry analysts for years, especially since the company surpassed American Eagle, a subsidiary of American Airlines, as the number one regional airline in 2006. The company enjoyed respectable profits even when other airlines produced flat earnings or lost money. Its reputation for being well run had been enhanced by its success in overcoming the operational problems of its Atlantic Southeast Airlines (ASA) subsidiary, which it had acquired from Delta Airlines in late 2005. At that time, ASA was known for its poor performance on baggage delivery and on-time arrival metrics. Within two years, ASA's standing on the Transportation Department's performance list improved from 20th to 10th place.[2] Exhibit 1 shows a map of the destinations served by the airlines of the combined company.

Despite its successes, SkyWest, Inc., was experiencing many challenges in late 2009. Probably foremost was the state of the economy and its overall effect on the airline industry. The airline industry was cyclical and its financial performance was highly correlated to the economy; recessions traditionally sent industry participants' income statements and balance sheets into the red. The most recent recession that had begun in 2007 was no exception. Reports highlighting airline losses, bankruptcies, and consolidations were in the news. An important issue for SkyWest was the state of its relationship with Delta Airlines, one of its two main code-share partners, with which it had a legal dispute over Delta's refusal to pay expenses which SkyWest claimed were due them based on their contract with Delta. The company believed it was owed nearly $25 million in payments, but it was also concerned that suing the much larger airline would dampen Delta's enthusiasm for sending more business their way.

Another important strategic issue was the wind-down of SkyWest's partnership with Midwest Airlines. The partnership had originally been announced with great fanfare in December 2006 and then expanded in January 2008. Midwest's subsequent bankruptcy and purchase by investment group TPG Capital was followed by the announcement on June 23, 2009, that the airline would be purchased by Republic Airways Holdings, a direct competitor of SkyWest.[3] In fact, Republic was purchasing not only Midwest Airlines but also Frontier Airlines, moves that would make Republic a

EXHIBIT 1 **Route Map for SkyWest Airlines and Atlantic Southeast Airlines, 2009**



Source: skywest.com.[3]

much larger company and extend its operations into flying larger airplanes covering greater distances. These capabilities would make them a much more formidable competitor in the future.

Fuel was another concern for SkyWest. Although SkyWest's contracts with its partners typically included compensation for fuel costs, there was some concern that availability could also become a problem, limiting the number of flights the company could support. A further issue involved stipulations in the "scope clauses" in the labor contracts that all airlines had with their pilots' unions that spelled out the maximum size of airplane that an outside partner could operate. Since all of SkyWest, Inc.'s business would be conducted in partnership with United and Delta (since the Midwest business was going away), "scope clauses" would limit the size of aircraft that they could fly in service of these contracts. Delta pilot contracts limited outside companies to 76-seat aircraft and United pilot contracts limited outside companies to 70-seat aircraft. Without these limitations, SkyWest could probably have purchased larger aircraft to take advantage of their efficiencies. With larger aircraft, the company could have captured more business from its partners.

The effect of the economic downturn on the company's 2008 and 2009 financial performance was readily apparent. Even though overall revenues and income grew in 2008, fourth-quarter results dragged down its overall yearly results. Operating revenues for the quarter ending December 31, 2008, were \$743.3 million—down from \$854.7 million the previous year—and reported income for the quarter was \$53.8 million—down from \$83.6 million. In the first quarter of 2009 ending on March 31, the company reported that, compared to the same quarter the previous year,

Exhibit 2

SkyWest, Inc.'s Consolidated Statements of Income (dollars and shares in thousands, except per share amounts)

	TWELVE MONTHS ENDED DECEMBER 31				
	2008	**2007**	**2006**	**2005**	**2004**
Operating Revenue					
Passenger	$3,466,287	$3,342,131	$3,087,215	$1,938,450	$1,139,580
Ground handling and other	29,962	32,201	27,441	25,598	16,464
Total operating revenues	3,496,249	3,374,332	3,114,656	1,964,048	1,156,044
Operating Expenses:					
Aircraft fuel	1,220,618	1,062,079	1,010,717	590,776	252,556
Salaries, wages and benefits	724,094	726,947	673,961	434,218	282,676
Aircraft maintenance, materials and repair	381,653	297,960	220,705	129,626	77,514
Aircraft rentals	295,784	294,443	281,497	281,496	210,496
Depreciation and amortization	220,195	208,944	189,885	115,275	76,817
Station rentals and landing fees	132,017	135,757	118,990	n.a.*	n.a.*
Ground handling services	106,135	140,374	134,034	n.a.*	n.a.*
Other	160,522	163,304	145,707	263,248	175,686
Total operating expenses	3,241,018	3,029,808	2,775,496	1,743,640	1,011,268
Operating Income	255,231	344,524	339,160	220,408	144,776
Other income (expense):					
Interest income	20,776	31,650	19,953	12,943	10,050
Interest expense	(106,064)	(126,320)	(118,002)	(53,330)	(18,239)
Other	6,240	467	(1,084)	(395)	—
Total other expense(net)	(79,048)	(94,203)	(99,133)	(40,782)	(8,189)
Income before income taxes	176,183	250,321	240,027	179,626	136,587
Provision for income taxes	63,254	91,129	94,221	67,359	54,635
Net income	$ 112,929	$ 159,192	$ 145,806	$ 112,267	$ 81,952
Basic earnings per share	$ 1.95	$ 2.54	$ 2.33	$ 1.94	$ 1.42
Diluted earnings per share	$ 1.93	$ 2.49	$ 2.30	$ 1.90	$ 1.40
Weighted average common shares:					
Basic	57,790	62,710	62,474	57,851	57,858
Diluted	58,633	64,044	63,382	58,933	58,350

Note: Increases between 2004 and 2005 are due in large part to the acquisition of ASA.

*Changes in reporting categories made these numbers unavailable.

Source: SkyWest, Inc.[5]

revenues at $672.6 million were down from $868.0 million, and operating income of $40.8 million was down from $68.2 million. In a discussion of these results, the company noted that approximately $18.3 million of the revenue decline was due to reductions in flight schedules made by the company's major partners. Lower fuel costs paid by partners and recorded as revenues accounted for $147 million of SkyWest's revenue decline during the first quarter of 2009. Additionally, ASA experienced significant weather-related cancellations at its Atlanta hub as well as the grounding of 60 regional aircraft in order to perform safety inspections recommended by the manufacturer, reducing revenues another $7.6 million. Finally, as a result of the ongoing negotiations regarding compensation of expenses with partner Delta Airlines, the company suffered a further $5 million reduction in revenues. SkyWest, Inc.'s consolidated statements of income for 2004 through 2008 are provided in Exhibit 2. The company's balance sheets for 2007 and 2008 are presented in Exhibit 3. Selected operating statistics for SkyWest, Inc., between 2004 and 2008 are shown in Exhibit 4.

Exhibit 3

SkyWest, Inc.'s Consolidated Balance Sheets (dollars in thousands)

ASSETS

	DECEMBER 31, 2008	DECEMBER 31, 2007
CURRENT ASSETS		
Cash and cash equivalents	$ 125,892	$ 122,802
Marketable securities	568,567	522,925
Restricted cash	10,728	14,705
Income tax receivable	14,868	23,114
Receivables, net	55,458	81,216
Inventories, net	104,383	105,738
Prepaid aircraft rents	226,474	223,891
Deferred tax assets	76,093	70,523
Other current assets	38,205	45,225
Total current assets	1,220,668	1,210,139
PROPERTY AND EQUIPMENT		
Aircraft and rotable spares	3,273,705	3,146,602
Deposits on aircraft	20,390	23,848
Buildings and ground equipment	239,573	215,466
	3,533,668	3,385,916
Less accumulated depreciation and amortization	(824,293)	(685,327)
Total property and equipment, net	2,709,375	2,700,589
OTHER ASSETS		
Intangible assets, net	26,247	28,498
Other assets	58,001	51,299
Total other assets	84,248	79,797
Total assets	$4,014,291	$3,990,525

LIABILITIES AND STOCKHOLDERS' EQUITY

	DECEMBER 31, 2008	DECEMBER 31, 2007
CURRENT LIABILITIES		
Current maturities of long-term debt	$ 129,783	$ 118,202
Accounts payable	110,902	133,728
Accrued salaries, wages and benefits	66,663	67,242
Accrued aircraft rents	25,676	26,516
Taxes other than income taxes	16,651	12,433
Other current liabilities	37,039	40,098
OTHER LONG-TERM LIABILITIES	386,604	398,219
Total current liabilities	41,525	40,355
LONG-TERM DEBT, net of current maturities	1,681,705	1,732,748
DEFERRED INCOME TAXES PAYABLE	507,113	445,993
DEFERRED AIRCRAFT CREDITS	121,823	127,203
COMMITMENTS AND CONTINGENCIES		
STOCKHOLDERS' EQUITY	—	—
Preferred stock, 5,000,000 shares authorized; not issued . . .		
Common stock, no par value, 120,000,000 shares authoried; 73,520,292 and 72,272,671 issued respectively	562,395	533,545
Retained earnings	977,736	871,874
Treasury stock, at cost, 17,150,580 and 11,794,056 shares, respectively	(261,174)	(158,542)
Accumulated other comprehensive loss	(3,436)	(870)
Total stockholders' equity	1,275,521	1,246,007
Total liabilities and stockholders' equity	$4,014,291	$3,990,525

Source: SkyWest, Inc., 2008 Annual Report.

Exhibit 4

Selected Operating Statistics for SkyWest, Inc.

	YEAR ENDED DECEMBER 31					
OPERATING METRIC	2008	2007	% CHANGE 2007–2008	2006	2005	2004
Passengers carried	33,461,819	34,392,755	(2.7)	31,465,552	20,343,975	13,424,520
Revenue passenger miles (000)	17,101,910	17,892,282	(4.4)	15,819,191	9,538,906	5,546,069
Available seat miles (000)	22,020,250	22,968,768	(4.1)	20,209,888	12,718,973	7,546,318
Passenger load factor	77.7%	77.9%	(0.2) pts	78.3%	75.0%	73.5%
Passenger break-even load factor	74.4%	72.9%	1.5 pts	72.9%	68.6%	65.5%
Yield per revenue passenger mile	$0.203	$0.187	8.6	$0.195	$0.203	$0.205
Revenue per available seat mile	15.9¢	14.7¢	8.2	15.4¢	15.4¢	15.3¢
Cost per available seat mile	15.2¢	13.7¢	10.9	14.3¢	14.1¢	13.6¢
Fuel cost per available seat mile	5.5¢	04.6¢	19.6	n.a.	n.a.	n.a.
Average passenger trip length	511	520	(1.7)	503	469	413
Number of operating aircraft at end of year	442	436	1.0	410	380	206

n.a. = not available.
Source: SkyWest, Inc.[4]

The Airline Industry

The global airline industry comprised firms primarily offering domestic and international air transportation of passengers and/or cargo over regular routes on regular schedules. Airlines operated flights even if they were only partially loaded. Companies whose main business was providing air transportation of mail on a contract basis were included in the industry.[5]

The U.S. Airlinel ndustry

There were three types of domestic airline carriers: (1) network, (2) low-cost, and (3) regional carriers. They operated under three different business models. Network carriers, often referred to as the "majors" or "legacy carriers," operated a significant portion of their flights using what is known as a hub and spoke system. In 2009, United, US Airways, Northwest, American, Continental, and Delta Airlines were the largest of this group. The merger of Northwest and Delta Airlines, approved on October 29, 2008, and expected to be completed within 12 to 24 months,[6] would leave this group with five large players.

Low-cost carriers were those that the industry generally recognized as operating under a low-cost business model most often using point-to-point flights. The largest carriers in this segment were Southwest and JetBlue Airlines. Several major carriers, in an effort to respond to the loss of revenues from low-cost competitors, had started up their own low-cost airlines. Two examples were United's Ted Airlines and Delta's Song Airlines.

Regional carriers provided service from small cities, using primarily regional jets, to support the network carriers' hub and spoke systems. Regional airlines were air carriers that specialized in short-haul flights that serviced small communities that had neither the facilities nor frequency of passenger travel to support a larger airport and the accompanying aircraft. The largest regional carriers operated under a business model that relied on contracts with major carriers to generate revenues. The regional carriers painted their airplanes with the colors and logos of the major carriers, and flights were operated under the codes of their major carrier partners.

Turbulence in the Industry

The U.S. airline industry had experienced more than its share of turbulence since the September 11, 2001, terrorist attacks on the World Trade Center and the Pentagon. This disruption, coupled with the major airlines' prior overexpansion and bloated flight schedules, increasing fuel costs, increased competitive pressures from low-cost carriers, and the post-9/11 fear of flying, translated into huge losses for the major carriers. Most major airlines started 2006 in serious financial trouble, if not bankruptcy. United Airlines and US Airways filed for bankruptcy in 2002 (with United emerging to post profits in 2006),[7] followed by ATA in 2004, and Northwest and Delta in September 2005. In the spring of 2008, both ATA and Aloha Airlines indicated that they would cease operations.

Some analysts believed that the U.S. airline industry, as it existed, was not sustainable and that the time was ripe for serious consolidations. In the fall of 2005, the US Airways–America West merger was finalized. In April 2008, Delta announced that a deal had been struck to acquire Northwest Airlines based in Minnesota.[8] The merger was expected to create the world's largest airline once operations were consolidated over the next two years. There had also been rumors of a potential merger between United and Continental Airlines.[9] Analysts viewed mergers from two perspectives. First, they had the potential to take out some of the excess capacity in the industry leading to more stable profits and less devastating price competition. This was viewed as positive. On the other hand, they were likely to be accompanied by higher debt and higher costs associated with merging the operations of two airlines. As many airlines were already struggling under heavy debt loads,[10] increased merger activity leading to higher debt could further destabilize the industry.

The industry was highly sensitive to fluctuations in the economy because a significant portion of travel by both leisure and business travelers was discretionary. The recession in the early 2000s lowered the overall demand for airline services in the United States. As 2009 began, a worldwide recession of a scale not seen since the Great Depression was expected to exacerbate the problems already affecting the industry. In December 2008, new forecasts from the International Air Transport Association (IATA) had predicted that worldwide passenger traffic, in response to the worldwide recession, would fall by 3 percent to $394 billion from $425 billion in 2008 and cargo revenues would fall to $54 billion from $59 billion. In its report, the IATA noted that weak travel markets due to recession had typically lasted three years, so travel was not expected to grow more than 4 percent until 2011.[11] It was well known that the most recent recession had also had a strong impact on credit markets. Airlines needed credit to acquire new aircraft.

Finally, the airline industry was affected by seasonal fluctuations that included increased travel during summer months and flight cancellations and delays owing to inclement weather primarily during the winter.[12] For example, SkyWest, Inc., reported that one storm during December 2006 led to a two-day closing of the Denver International Airport and the subsequent cancellation of 2,850 of its flights. The weather-related flight cancellations resulted in a decrease in SkyWest pretax income of approximately $5.2 million.[13]

AirlineP assengers

There were two main types of passengers in the airline industry: business travelers and leisure travelers. Business travelers tended to be more profitable for airlines because they flew more often. Also, a great deal of business travel was not planned very far in advance, forcing business travelers to purchase tickets at a premium. Leisure passengers traveled less and were more price sensitive than business travelers. The regional airlines, primarily through their contracts with the major carriers, serviced both market segments; however, their passenger base had historically been made up of more business travelers than leisure travelers. Business travelers used regional airlines to commute to and from locations that were considered too far to drive.

Traditionally, the major airlines, through their partnerships with regional airlines, serviced almost the entire business market. However, an increasing number of business travelers had begun to travel on low-cost carriers. The major airlines' share of the business market had dropped to 60 percent, while the low-cost carriers had picked up 20 percent. The major airlines were responding to these competitive pressures by offering their own low-cost carrier lines, such as United's Ted and Delta's Song. These moves were expected to potentially lower overall demand for routes traditionally served by the regional carriers.

Safety

The September 11, 2001, terrorist attacks on the United States were a major contributor to the decreased demand in the airline industry in the early 2000s. People were afraid to fly and, in an uncertain economy, this translated into less revenue for the major airlines. This factor likely did not directly affect regional airlines because of the assumption that a smaller regional aircraft wouldn't be a target for terrorism. However, since regionals derived most, if not all, of their revenues from contracts with the majors, they were affected as well. Regional airlines also suffered from the general view that smaller airplanes were less safe than larger airplanes. In reality, regional airlines had a slightly lower accident rate than the major airlines and had increased safety standards in recent years. Two dramatic airline disasters within weeks of each other in early 2009 again focused media attention on safety.

Regulation

The airline industry in the United States was regulated by the Federal Aviation Administration (FAA), the Department of Transportation (DOT), and the Transportation Security Administration (TSA). Post-9/11 fears of terrorist attacks had led to stepped-up government intervention in the industry through increased security regulations, leading to additional costs for the airlines.

Each new government regulation of the industry created additional costs for airlines. For example, the Department of Transportation had considered implementing a regulation (amending the Air Carrier Access Act of 1986) to require airlines to provide oxygen for passengers that needed oxygen. The proposal, if enacted, would have increased regional airlines' costs since equipment would have needed to be purchased and maintained and personnel trained to properly use the equipment. The cost for this regulation had been estimated to be between $262 million and $577 million to the airline industry over 10 years.[14]

FuelC ostI ncreases

The increasing price of jet fuel had been a contributing factor to the financial troubles of the major airlines. Before the unprecedented increases in fuel costs experienced by the airline industry in 2008, the costs of fuel had made up 10–20 percent of overall airline costs with 14–16 percent being the average.[15] Although fuel costs during 2008 had receded somewhat by the end of the year, most analysts didn't expect much relief in fuel costs in the foreseeable future. At the beginning of 2009, fuel expenses ranged from 35 to 50 percent of an airline's operating costs.[16] In response to the threat of rising fuel costs, most of the major airlines implemented stringent luggage restrictions, with stiff fees for passengers who exceeded specified limits. Increased fuel costs were also a threat to regional carriers as their major airline partners pressured them for lower fees.[17]

LaborU nions

The airline business had always been highly labor intensive. It was estimated that 40 percent of an airline's expenses comprised pay for airline professionals such as pilots, flight attendants, baggage carriers, customer service personnel, etc.[18] Most airline employees were represented by one of many labor unions including the Airline Pilots Association and the Allied Pilots Association, the Professional Flight Attendants Union, the Transportation Workers Union, the International Association of Machinists, and the Airline Professional Flight Attendants Association. Labor unions and airlines had a history of acrimonious relationships leading to strikes and huge losses for the airlines affected. Some analysts who followed the industry anticipated that labor unions would see any return to profits for the industry as an opportunity to lobby for wage and salary increases.[19]

TheR egional Airline Industry

The regional airline industry was made up of air carriers that specialized in short-haul flights that serviced small communities which had neither the facilities nor frequency of passenger travel to support a larger airport and the accompanying aircraft. Initially, regional airlines operated small, slow planes in one general geographic area. As the industry grew and regional companies partnered with the major airlines, they began to increase their reach. The introduction of faster, more efficient commuter jets also helped the regional airlines expand their service areas. A major portion of regional airline growth was attributed to the development of smaller regional jets that could be flown on routes that the majors had previously serviced through the use of larger 737s, DC9s, MD80s and A319s. In 2009, the six major U.S. airlines had a significant number of older aircraft of these models. Their potential retirement created opportunities for regional partners to take over the routes that these aircraft previously flew.

Regional airlines primarily operated to serve as feeder airlines bringing passengers to and from small communities to a large hub airport to connect with larger airlines with larger aircraft and greater geographic reach. About 95 percent of regional airlines' business served this purpose.[20] Other regional airlines were formed to serve particular low-use routes and were often most important to small and isolated communities for whom the airline was the only reasonable link to a larger town.

Regional airlines operated mostly through partnerships with the major airlines. Some regional airline companies such as SkyWest, Inc., were independent entities; often, however, regionals were wholly owned subsidiaries of major airlines where the separate corporate structure allowed the subsidiary to operate under different (and lower) pay schedules. Examples of such subsidiaries included American Eagle, Canada Air Jazz, Comair, and Continental Express. When a regional airline entered into a partnership with a major carrier, the major carrier paid the regional airline a contracted fee per departure. The major carriers relied on the regional airlines to make their hubs work efficiently, and the regional airlines gained access to an established customer base and a steady revenue stream. Under these conditions, the revenues of regional airlines were not directly related to ticket sales generated by the regional carrier. A passenger wanting to travel along a route served by a regional airline would book his or her flight with a major carrier that had a partnership with the regional. The passenger was the customer of the major carrier and the identity of the regional airline was not normally of concern or interest to the passenger.[21] A list of partnerships between major air carriers and regional airlines is presented in Exhibit 5.

Regional airlines were subject to a number of operating constraints and problems that their major carrier partners did not face. Regional airlines often fared poorly in periodic releases of the Airline Quality Report, but many of the problems cited were beyond the control of the regional airlines. For example, Atlantic Southeast Airlines, owned by SkyWest, Inc., came in worst for bumping passengers due to overselling seats even though it was Delta Airlines that was responsible for overselling its flights.[22] In one rating in the third quarter of 2006, four of the worst on-time records were held by regional carriers. The six worst carriers

Exhibit 5

Regional Airline Partnerships (as of September 2008)

MAINLINE CARRIER	REGIONAL BRAND	OPERATING PARTNERS
Alaska Airlines	N/A	Horizon Air Peninsula Airways
America Airlines	American Eagle American Connection	American Eagle American Eagle/Executive Chautauqua Airlines Tran States Airlines
Continental Airlines	Continental Express Continental Connection	Chautauqua Airlines ExpressJet Cape Air Colgan Air Commut Air Gulfstream International Airlines
Delta Air Lines	Delta Connection	Atlantic Southeast Airlines Chautauqua Airlines Comair Freedom Airlines Pinnacle Airlines Shuttle America SkyWest Airlines
Frontier Airlines	N/A	Great Lakes Lynx Aviation
JetBlue Airways	N/A	Cape Air
Midwest Airlines	Midwest Connect	SkyWest Airlines Republic Airlines (as of 10/1/2008)
Northwest Airlines	N/A NWA Airlink	Compass Airlines Mesaba Aviation Pinnacle Airlines
United Airlines	United Express	Chautauqua Airlines Colgan Air Gojet Airlines Great Lakes Mesa Airlines Shuttle America SkyWest Airlines Trans States Airlines.
US Airways	US Airways Express	Air Wisconsin Chautauqua Airlines Colgan Air Mesa Airlines Piedmont PSA Republic Airlines Trans States Airlines

in baggage handling were all regionals and six of the seven worst carriers for cancelling flights were also regionals. As the ASA example above illustrates, many of the regionals' problems were caused by their partners. The partners controlled the regionals' scheduling, not allowing enough time to load and unload passengers and luggage. In addition, regional carriers, which were usually limited geographically to one region, were more affected by bad weather.

At some hub airports, regional carriers' flights were routinely cancelled to make room on runways for major carrier airplanes when the weather was bad.[23]

The financial troubles of the major airlines during the 2000s created both opportunities and threats for their regional partners. The majors, in an attempt to stop the flow of red ink, rolled back operations and outsourced more of their routes to the regional airlines. This created opportunities for the regional carriers to expand their service areas and often put them into direct competition with the low-cost carriers, such as Southwest and Jet Blue. Increased pressure on the major carriers to cut costs also forced them to put pressure on their regional partners to accept lower fees. Furthermore, the bankruptcy filings of major carriers increased the risk of regionals whose partners were in reorganization. Such regionals found it necessary to expand their base of partnership contracts and develop more revenue sources. When Northwest Airlines filed for bankruptcy protection on September 14, 2005, its major regional partner, Mesaba Airlines, followed suit on October 13, 2005, citing the $30 million due it in the Northwest Chapter 11 Case.[24]

It was expected that the potential mergers of several of the major airlines could also create tougher times for their regional partners. Consolidations would mean more limited growth opportunities for the regionals that moved the majors' passengers to their hubs from smaller cities. Consolidations would allow carriers to shut down some of their hubs around the country, especially some of the smaller ones that depended more on regional airline flights.[25]

Aircraft

There were two major choices of type of aircraft used by regional carriers: the turboprop and the regional jet. The uses for these two aircraft differed and complemented each other. The turboprop was used for short- to medium-haul flights and was able to land on shorter runways. Many travelers were hesitant to ride on turboprops, given the perception that they were loud and uncomfortable. Some of the major turboprops included the Embraer EMB 120, a twin-engine 30-passenger aircraft manufactured by Brazil's Empresa Brasileira de Aeronautica SA, the Jetstream 41, Saab 340, ATR 72, Dornier 328, the de Havilland Dash 8-100 and -200, and the Bombardier Q Series turboprop, which was equipped with noise and vibration reduction devices that reduced the noise and vibration levels to those of a regional jet.

Regional jets, on the other hand, had increasingly been used to service longer-haul flights to destinations up to 1,200 miles away. The Bombardier Regional Jet (the CRJ 200, CRJ 700, and CRJ 900) was the main regional jet used in the industry. Its introduction allowed the regional carriers to operate new longer routes and run shorter routes more efficiently.

Competition

Like competition among the majors and low-cost carriers, competition among the regional airlines had become increasingly fierce as the regional airlines competed with each other for partnerships with only a few major airlines. Rivalry was expected to continue to increase as the regional airlines competed for new routes being offered and bid out by the major airlines. To be able to successfully acquire contracts with the majors, a regional airline was required to:

- Develop and maintain high levels of customer service: Airlines had become notorious for providing poor customer service by mishandling baggage and cancelling flights. However, many times regional airlines' baggage problems were attributed to scheduling decisions by partners which did not allow enough time between their flights and the regional's to transfer luggage. As mentioned above, inclement weather could force flight cancellations for regionals when runway priority was given to the majors.
- Develop and maintain a strong safety image: Passengers would not fly with an airline that had an unsafe image.

- Maximize on-time arrivals: To ensure passengers continued to fly with a regional airline, the airline was required to deliver passengers to their destination on time so passengers did not miss their connecting flight.
- Acquire new aircraft: Regional airlines needed capital and financing to increase the size of their fleets to service the longer routes being outsourced by the major airlines. Yet they had to be able to do this without compromising their scope contractsw ithl abor.

SkyWest, Inc., viewed its main rivals in the regional airline industry to be Air Wisconsin Airlines Corporation, American Eagle Airlines ("American Eagle") (owned by American), Comair ("Comair") (owned by Delta), ExpressJet Holdings, Inc. ("ExpressJet"), Horizon Air Industries, Inc. ("Horizon") (owned by Alaska Air Group, Inc.), Mesa Air Group, Inc. ("Mesa"), Pinnacle Airlines Corp. ("Pinnacle"), Republic Airways Holdings Inc. ("Republic"), and Trans State Airlines, Inc.[26] Selected consolidated operating and financial data for the five largest independent regional airlines in the United States for 2004 through 2008 is presented in Exhibit 6. Exhibit 7 provides operating revenues for each of the five largest regional carriers between 2004 and 2008. Exhibit 8 provides a comparison of operating costs per passenger revenue mile for the five largest regional carriers for 2004 through 2008.

A brief overview of SkyWest, Inc.'s major independent competitors is given below:

Mesa Air Group, a publicly held company, operated 188 aircraft with over 1,100 daily system departures to 173 cities,

Exhibit 6

Selected Consolidated Operating and Financial Data for the Five Largest U.S. Independent Regional Airlines, 2004–2008

	2008	2007	2006	2005	2004
Passengers (in thousands)	94,389	95,532	85,799	62,775	46,051
Flights (in thousands)	2,462	2,601	2,231	2,206	1,880
Revenue passenger miles (in millions)	47,808	48,323	43,827	33,308	23,956
Available seat miles (in millions)	63,308	63,657	57,186	45,700	33,901
Passenger load factor	75.5%	75.9%	76.6%	72.9%	70.7
Passenger revenues (in millions)	$8,374	$8,355	$7,968	$6,321	$4,784

Source: Annual Reports of SkyWest, Inc., Mesa Air Group, ExpressJet Holdings, Inc., Republic Airways Holdings, Inc. and Pinnacle Airlines Corp. Years 2004–2008.

Exhibit 7

Operating Revenues of the Five Largest U.S. Independent Regional Airlines, 2004–2008 (in millions)

	2008	2007	2006	2005	2004
SkyWest, Inc.	$3,496	$3,374	$3,115	$1,964	$1,156
Mesa Air Group, Inc.	1,316	1,372	1,183	943	741
ExpressJet Holdings, Inc.	1,318	1,686	1,682	1,563	1,508
Republic Airways Holdings, Inc.	1,480	1,293	1,143	905	646
Pinnacle Airlines Corp.	865	787	825	842	635

Exhibit 8

Comparative Operating Cost Statistics for Major U.S. Regional Airlines, 2004–2008 (costs per passenger revenue mile in cents)

YEAR	WAGES AND BENEFITS COMPENSATION	MAINTENANCE	FLEET RENTAL COSTS	LANDING FEES AND GROUND HANDLING	FUEL	DEPRECIATION AND AMORTIZATION	OTHER
SkyWest, Inc.							
2008	4.2¢	2.2¢	1.7¢	1.4¢	7.1¢	1.3¢	0.9¢
2007	4.1	1.7	1.6	1.5	5.9	1.2	0.9
2006	4.3	1.4	1.8	1.6	6.4	1.2	0.9
2005	4.6	1.4	3.0	n.a.	6.2	1.2	2.8
2004	5.1	1.4	3.8	n.a.	4.6	1.4	3.2
ExpressJet Holdings, Inc.							
2008	4.2	2.1	2.1	1.7	2.4	0.3	0.3
2007	4.3	2.1	3.4	2.1	3.2	0.3	0.3
2006	3.8	1.9	3.2	2.1	2.2	0.3	1.8
2005	3.9	2.0	3.5	2.2	2.4	0.3	1.8
2004	4.3	2.1	3.8	2.6	2.5	0.3	2.3
Pinnacle Airlines Corp							
2008	4.1	1.7	2.4	3.1	0.9	0.5	2.2
2007	4.0	1.8	2.8	3.2	0.8	0.2	2.2
2006	3.3	0.8	6.2	3.0	2.5	0.1	1.5
2005	3.2	0.8	6.7	1.0	2.7	2.2	1.4
2004	3.6	0.8	7.2	1.3	2.9	2.3	1.4
Republic Airways Holdings Inc.							
2008	2.6	1.7	1.4	0.6	3.4	1.4	1.6
2007	2.6	1.5	1.4	0.6	3.5	1.2	1.2
2006	2.6	1.6	1.4	0.6	4.9	1.4	1.5
2005	3.2	1.7	1.7	0.7	6.2	1.4	1.7
2004	3.7	2.3	2.4	0.8	5.7	1.1	2.1
Mesa Air Group, Inc.							
2008	n.a.	4.3	n.a.	1.3	8.6	0.6	0.9
2007	n.a.	3.7	n.a.	1.2	6.3	0.6	2.5
2006	n.a.	3.1	n.a.	1.1	6.5	0.5	0.7
2005	n.a.	3.2	n.a.	1.1	4.9	0.7	1.2
2004	n.a.	3.2	n.a.	1.3	3.9	0.6	1.6

Costs categories are divided by Passenger Revenue Miles reported in Annual Reports.
n.a. Not available. Some costs not available in annual reports or 10Ks.

Sources: Annual Reports and 10Ks for SkyWest, Inc., ExpressJet Holdings, Pinnacle Airlines Corp., Republic Airways Holdings Inc. and Mesa Air Group, Inc. for years 2005, 2006, 2007, and 2008; all fiscal years ending on December 31 except Mesa Air Group fiscal years ending on September 30.

46 states, the District of Columbia, Canada, and Mexico. On December 22, 2006, the Mesa Air Group signed an agreement with Shenzhen Airlines to create a new regional airline through a joint venture. The new airline was expected to have twenty 50-seat regional jets flying prior to the Beijing Olympic Games in 2008. The company also operated partnerships with United Airlines, US Airways, Midwest Airlines, and

Delta Airlines. Wholly owned subsidiaries included:

- **Air Midwest,** doing business as **Mesa Airlines,** primarily served federally subsidized markets across the country through a fleet of twenty 19-passenger, Raytheon1900D Aircraft.
- **Freedom Airlines, Inc.,** operated Delta Connection services primarily in the southeast.
- **Go! Hawaii Airlines** was a low-cost inter-island airline operated by Mesa Airlines that flew 66 routes per day between the islands of Hawaii.[27]

Republic Airways Holdings, based in Indianapolis, Indiana, was an airline holding company that operated Chautauqua Airlines, Republic Airlines, and Shuttle America. The airlines offered scheduled passenger service on approximately 1,200 flights daily to 119 cities in 38 states, Canada, Mexico, and the U.S. Virgin Islands through airline services agreements with four major U.S. airlines. All of the airlines' flights were operated under their major airline partner's brand, such as American Connection, Delta Connection, Frontier Airlines, United Express, and US Airways Express. As of December 2008, the combined airlines employed over 4,700 people and operated 219 regional jets.[28] However, in June 2009, the company announced plans to acquire both Midwest Airlines (one of its partners) and Frontier Airlines, moves that would significantly increase its size and bring it into direct competition with legacy and low-cost carriers.

ExpressJet Holdings was a publicly held company with operations in the air transportation sector, including ExpressJet Airlines, Inc. (which operated under the name Continental Express), and ExpressJet Services, LLC, which provides third-party maintenance services. The company was also invested in other entities that permitted it to leverage the management experience, efficiencies, and economies of scale. ExpressJet Airlines operated as Continental Express flying 1,000 departures per day and serving 125 destinations in North America and the Caribbean. It operated hubs in New York/Newark, Cleveland, and Houston. ExpressJet Airlines employed about 8,000 people.[29]

Pinnacle Airlines Corp., headquartered in Memphis, Tennessee, was the parent holding company of Pinnacle Airlines and Colgan Air, Inc. Until 2003 it had been a wholly owned subsidiary of Northwest Airlines. Pinnacle Airlines conducted its operations under the name of Northwest Airlink, providing flights from Northwest hubs in Detroit, Memphis, Minneapolis/St. Paul, and Indianapolis and as Delta Connection. As of December 31, 2008, the airline employed 5,644 people. Pinnacle Airlines flew 142 regional jets and Colgan Air flew an all-turboprop fleet under regional connect contracts for United, Continental, and US Airways to these locations. Colgan Air was involved in one of two airline disasters in early 2009 when its Continental Connect flight 3407 crashed into a home on the ground on the way to the Buffalo, New York, airport killing all 49 people on board and one on the ground. On January 27, 2009, the company announced limited workforce reductions and other cost-cutting measures needed to address the Delta-NWA merger and the economic slowdown.[30]

SkyWest, Inc.

SkyWest, Inc., was founded as SkyWest Airlines in 1972 in St. George, Utah, to facilitate "the connections of passengers to flights of major partners" by partnering with the major airlines to service smaller airports and shorter routes. The struggling airline acquired Palm Springs–based Sun Aire in 1984, entered its first code-share contract with Western Airlines in 1985, and in 1986 went public. With its first stock offering, the company was able to pay off some of the debt on its aircraft. Western was purchased by Delta Airlines later that year, putting SkyWest in a position to compete for more code-share contracts. Since 2002, the company had been named the Regional Airline Company of the Year by two airline magazines and its subsidiary, SkyWest Airlines, had been named the number one on-time airline by the Department of Transportation several times. In 2005 the company completed the acquisition (from Delta Airlines) of Atlantic Southeast Airlines (ASA), a regional airline based in Atlanta. In June 2007, the company celebrated its 35th anniversary.[31]

At the beginning of 2009, the company continued to operate its SkyWest and ASA operations as separate companies although it was seeking to reduce costs in some parts of its operations through combining activities in finance, treasury, IT, and administrative services to realize economies. The company explained that it maintained separate operations to identify best practices that could be applied to both airlines.

SkyWest, Inc., operated primarily through partnership contracts with United and Delta. The two legacy carriers had both been in bankruptcy protection with United emerging from the proceedings early in 2006 and Delta coming out of bankruptcy in April 2007. SkyWest, Inc., relied almost completely on these carriers for its customers and revenue. Because both United and Delta operated with very similar business models and were exposed to the same types of economic and environmental risks, SkyWest, Inc.'s revenues had become less predictable and more risky.

In an effort to diversify its risk, the company entered into an agreement with Midwest Airlines in December 2006 to fly some of its connector routes, an agreement that was expanded in January 2008 when SkyWest took over all of Midwest Airlines' regional connecting flights.[32] It was intended that these contracts expand and diversify operations and thereby reduce the dependence on United and Delta. However, the relationship was expected to end since Midwest had been acquired by Republic Airways Holdings in 2009.

SkyWest Airlines

At the beginning of January 2009, SkyWest Airlines operations served 158 cities in 42 states, five Canadian provinces, and Mexico. Its hubs were in Chicago O'Hare, Los Angeles, San Francisco, Milwaukee, Portland, Denver, San Francisco, and Salt Lake City; maintenance bases were in Atlanta, Chicago, Colorado Springs, Denver, Fresno, Los Angeles, Milwaukee, Palm Springs, Portland, Salt Lake City, San Francisco, and Tucson. The airline employed more than 11,000 people who were not represented by union contracts.[33]

SkyWest Airlines had a good reputation for safety, on-time arrivals, and other factors affecting customer satisfaction. In 2009, SkyWest was tied for first among regional carriers for on-time arrivals, had an average number of mishandled baggage reports, had the second fewest number of involuntary denied boardings, and was fourth among regional carriers in number of complaints per 100,000 passengers. Exhibit 9 provides comparisons among regional airlines on various customer service criteria from 2004 to2009.

AtlanticS outheast Airlines

Atlantic Southeast Airlines was founded in 1979 in Atlanta. In 1984, ASA was selected by Delta Air Lines as one of the first partners in the Delta Connection program. After 15 years of partnership, ASA was acquired by Delta Airlines in 1999. During the next six years, the company's fleet grew by 100 aircraft. In 2005, the airline was acquired by SkyWest, Inc.

By the end of June 2009, ASA served 130 airports with 155 aircraft in 30 U.S. states, Washington, DC, Canada, Mexico, Belize, the Bahamas, Jamaica, Puerto Rico, and the Turks and Caicos Islands. The carrier had hubs in Atlanta, Salt Lake City, Los Angeles, and Cincinnati. Its maintenance stations were in Atlanta; Macon, Georgia; Salt Lake City; Baton Rouge; Shreveport, Louisiana; Columbia, South Carolina; Fort Walt Beach, Florida; and Montgomery, Alabama. The airline employed 3,700 full-time employees, who were represented by

Exhibit9

On-Time Flights, Mishandled Baggage, Denied Boardings, and Passenger Complaints for Major U.S.Regional Airlines, 2004–2009

PERCENTAGE OF SCHEDULED FLIGHTS ARRIVING ON TIME (PREVIOUS 12 MONTHS ENDING IN MAY OF EACH YEAR)

CARRIER	2004	2005	2006	2007	2008	2009
AMERICAN EAGLE	75.2%	75.3%	74.4%	70.2%	68.8%	76.3%
ATLANTIC SOUTHEAST	78.6	72.5	71.3	64.2	66.4	70.8
COMAIR	n.a.	77.3	80.9	67.6	69.5	65.7
EXPRESSJET	79.8	76.9	74.0	72.5	73.8	81.6
MESA	78.2	n.a.	n.a.	71.4	73.1	81.6
PINNACLE	n.a.	n.a.	n.a.	n.a.	74.9	86.8
SKYWEST	85.3	82.8	80.3	75.3	76.5	86.8

MISHANDLED BAGGAGE REPORTS PER 1,000 PASSENGER (IN MAY OF EACH YEAR)

CARRIER	2004	2005	2006	2007	2008	2009
AMERICAN EAGLE	8.38	7.89	12.51	11.60	9.06	7.44
ATLANTIC SOUTHEAST	10.94	14.50	11.33	7.74	5.81	6.24
COMAIR	8.89	8.37	7.73	8.84	5.86	4.63
EXPRESSJET	5.45	5.10	7.15	7.46	5.52	2.86
MESA	n.a.	n.a.	7.92	9.95	7.61	4.32
PINNACLE	n.a.	n.a.	n.a.	6.30	4.87	4.53
SKYWEST	7.94	8.11	6.85	9.21	5.76	4.92

INVOLUNTARY DENIED BOARDINGS PER 10,000 PASSENGERS DUE TO OVERSOLD FLIGHTS (JANUARY THROUGH MARCH OF EACH YEAR)

CARRIER	2004	2005	2006	2007	2008	2009
AMERICAN EAGLE	0.38	0.79	2.15	1.19	2.79	3.14
ATLANTIC SOUTHEAST	3.20	2.68	6.89	5.43	5.22	3.94
COMAIR	4.58	1.08	2.97	3.32	4.48	3.17
EXPRESSJET	n.a.	n.a.	n.a.	n.a.	n.a.	2.39
MESA	n.a.	n.a.	1.70	1.94	1.19	1.21
PINNACLE	n.a.	n.a.	n.a.	n.a.	4.71	1.60
SKYWEST	0.00	0.70	1.26	2.73	2.02	1.57

COMPLAINTS PER 100,000 PASSENGERS BOARDED (IN MAY OF EACH YEAR)

CARRIER	2004	2005	2006	2007	2008	2009
AMERICAN EAGLE	0.48	0.32	0.88	1.26	0.39	0.71
ATLANTIC SOUTHEAST	0.23	0.28	0.95	0.57	0.27	0.52
COMAIR	0.36	0.26	0.00	1.22	0.56	0.96
EXPRESSJET	0.00	0.30	0.31	0.35	0.40	0.36
MESA	n.a.	n.a.	0.69	0.58	0.60	0.63
PINNACLE	n.a.	n.a.	n.a.	0.91	0.97	0.33
SKYWEST	0.39	0.36	0.36	0.63	0.28	0.57

Note: Atlantic Southeast Airlines and SkyWest Airlines are operating companies of SkyWest, Inc., but are reported separately in this report. n.a. = not available

Source: Office of Aviation Enforcement and Proceedings, Air Travel Consumer Report, 2004–2009.

the Air Line Pilots Association, International, the Association of Flight Attendants–CNA, and the Professional Airline Flight Control Association. The airline, despite difficulties it had had with its unions, had never experienced a work stoppage due to a labor dispute and considered its relationship with its employees to be good.[34]

Prior to its being acquired by SkyWest, Inc., ASA, under its ownership by Delta Airlines, had one of the worst customer service records in the industry. In August 2005, ASA flights were on time only 59.6 percent of the time, which was the worst out of all reporting airlines. ASA also cancelled 8 percent of its flights and its rate of luggage mishandling was 19.95 reports out of 1,000. Both rates were the worst in the industry. The airline's performance on measures of customer service had improved significantly since being acquired by SkyWest, Inc., but still ranked last or near last among regional carriers in 2009 (see Exhibit 9).

Partnerships

Partnership contracts with the two airlines were fairly complex and provided for a number of fixed fees and incentives as well as provisions for early cancellation. SkyWest, Inc., operated Delta Connection contracts through both of its airline operations. The combined Delta Connection contracts represented approximately 59.9 percent of the company's capacity. Approximately 40.1 percent of capacity was dedicated to its United Express contracts.

DELTA CONNECTION As of December 31, 2008, SkyWest Airlines was operating approximately 430 Delta Connection flights per day between Salt Lake City and designated outlying destinations. Delta was entitled to all passenger, cargo, and other revenues associated with each flight. In exchange for providing the designated number of flights and performing SkyWest Airlines' other obligations under the SkyWest Airlines Delta Connection Agreement, SkyWest Airlines received from Delta on a weekly basis (1) reimbursement for 100 percent of its direct costs related to the Delta Connection flights plus (2) a fixed dollar payment per completed flight block hour, subject to annual escalation at an agreed rate. Costs directly reimbursed by Delta under the SkyWest Airlines Delta Connection Agreement included costs related to fuel, ground handling, and aircraft maintenance and ownership.[35]

Under the Atlantic Southeast Airline Delta Connection Agreement, the company operated more than 775 Delta Connection flights per day between Atlanta, Cincinnati, Salt Lake City, and designated outlying destinations. Under the Agreement, Delta was entitled to all passenger, cargo, and other revenues associated with each flight. Commencing in 2008, ASA was guaranteed to maintain its percentage of total Delta Connection flights that it had in 2007, so long as ASA's bid for additional regional flying was competitive with other regional carriers. In exchange for providing the designated number of flights and performing ASA's other obligations under the ASA Delta Connection Agreement, ASA received from Delta on a weekly basis (1) reimbursement for 100 percent of its direct costs related to Delta Connection flights plus (2) if ASA completed a certain minimum percentage of its Delta Connection flights, an amount equal to a certain percentage of the direct costs related to the Delta Connection flights (not including fuel costs). Costs directly reimbursed by Delta under the ASA Delta Connection Agreement included costs related to fuel, ground handling, and aircraft maintenance and ownership.[36] The ASA Delta Connection Agreement was scheduled to terminate on September 8, 2020, unless Delta elected to exercise its option to extend.[37]

UNITED EXPRESS At the end of December 2008, SkyWest Airlines offered approximately 900 scheduled departures for United Airlines under its United Express Agreement. Under the Agreement, SkyWest Airlines received, from United, compensation (subject to an annual adjustment) of a fixed-fee per completed block hour, fixed-fee per completed departure, fixed-fee per passenger, fixed-fee for overhead and aircraft costs, and one-time start-up costs for each aircraft delivered. The United Express Agreement provided for incentives based upon SkyWest Airlines' performance, including on-time arrival performance and completion percentage rates. Additionally, certain of SkyWest Airline's operating costs were reimbursed by United, including costs related to fuel and aircraft ownership and maintenance. Expiration of these contracts, unless options for renewals were exercised, was expected to occur incrementally in 2011, 2013, and 2015.[38]

MIDWEST CONNECT Under the terms of its December 21, 2006, agreement, SkyWest Airlines' operations extended to serving markets from Midwest Airlines' hubs in Milwaukee and Kansas City. The agreement provided for an initial term of five years with automatic two-year extensions thereafter. Commenting on the new agreement, Bradford R. Rich, Executive Vice President, CFO and Treasurer for SkyWest, Inc., said, "SkyWest and Midwest have similar corporate cultures and great reputations for quality customer service and we believe that our partnership will be beneficial for customers, employees, and shareholders. . . . This transaction also furthers certain of our strategic diversification objectives."[39] In January 2008, SkyWest took over all of Midwest's regional connecting flights.[40] However, with the financial troubles of the airline and takeover by Republic Airways, the contracts were expected to end in the very near term.

Safetyan dM aintenance

SkyWest, Inc's safety department voluntarily participated in the Aviation Safety Action Program, which was a reporting program for pilots designed to determine potential safety hazards. Additionally, the department served as a compliance liaison between SkyWest and the Department of Transportation and the Federal Aviation Administration. SkyWest, Inc., had also implemented Stetson Quality Suite, which was mobile data collection and reporting software used to ensure its companies were meeting or exceeding its safety and quality standards.

The company performed all routine airframe and engine maintenance and periodic inspection of equipment at their respective maintenance facilities. Nonroutine maintenance was handled through contracts with third parties.[41] The company scheduled two hours of maintenance for every one hour in flight. Mechanics conducted line service inspection of each aircraft every fifth day. In addition, the company's proactive safety and maintenance policies required that when a manufacturer of an airplane issued a service bulletin on any component of a plane that impacted safety, the company immediately carried it out ahead of a mandatory directive from the FAA. The airlines also provided the vast majority of training to both company pilots and maintenance personnel at their training facilities. The company's six-week maintenance training program was so comprehensive and respected that it attracted tuition-paying FAA personnel.[42]

HumanR esourceP olicies

Prior to the acquisition of Atlantic Southeast Airlines, the company's workforce was nonunion and its competitive salaries and bonuses, rapid promotion of pilots, retirement plan, and employee stock purchase plan created a level of employee satisfaction that discouraged the unionization of its workforce. The nonunion workforce gave SkyWest Airlines more flexibility in making decisions when compared to its competitors. For example, SkyWest's pilots agreed to operate 70- and 90-seat aircraft at the same rate as 50-seat aircraft. The 2005 acquisition of Atlantic Southeast Airlines changed SkyWest, Inc.'s relationship with its workforce as ASA's employees were represented by the Air Line Pilots Association, International, the Association of Flight Attendants–CNA, and the Professional Airline Flight Control Association. The airline acknowledged that there existed significant risk to the company should the labor unions associated with their ASA operations seek a "single carrier determination" from the National Mediation Board and attempt to unionize SkyWest Airlines' employees. Despite several attempts by the ALPA to unionize SkyWest Airlines, the sister company had remained union free.

Employees of both SkyWest Airlines and Atlantic Southeast Airlines were eligible to participate in company retirement plans where the company matched, up to a certain point, participant contributions. Employees who completed 90 days or more of service were also eligible to participate in the company Stock Purchase Plan.[43] In addition to these programs, the company offered a full array of generous benefits including a credit union, wellness program, medical, dental, and vision benefits, income protection, travel discounts, an educational savings plan, and a complete package of life and disability insurance programs.[44]

SkyWest,I nc.'sF leet

At the beginning of January 2009, the airline fielded a fleet of 442 aircraft—a mix of 56 Embraer EMB 120 twin-turboprop aircraft, 374 Bombardier Regional Jets (with 10 more to be acquired in 2009), and 12 ATR 72 twin-turboprop aircraft. To facilitate the company's expansion plans and improve efficiencies, SkyWest Airlines and Atlantic Southeast Airlines had combined firm orders to acquire additional aircraft. The new regional aircraft were expected to be more cost-efficient to operate than older models, which was important given the increasing costs of operating aircraft.[45]

BOMBARDIER REGIONAL JETS The Bombardier Regional Jets were among the quietest commercial jets available and offered many of the amenities of larger commercial jet aircraft, including flight attendant service, as well as a stand-up cabin, overhead and underseat storage, lavatories, and in-flight snack and beverage service. The speed of Bombardier Regional Jets was comparable to larger aircraft operated by the major airlines, and they had a range of approximately 1,600 miles. However, because of their smaller size and efficient design, the per-flight cost of operating a Bombardier Regional Jet was generally less than that of a 120-seat or larger jet aircraft. The majority of the company's aircraft were these smallj ets.

EMBRAER AND ATR TURBOPROPS
The 30-seat Embraer EMB 120 turboprops and 74-seat ART 72 turboprops were able to operate more economically over short-haul routes than larger jet aircraft. These factors made it economically feasible to provide high frequency service in markets with relatively low volumes of passenger traffic. Passenger comfort features of the Embraer and ATR turboprops included stand-up headroom, a lavatory, overhead baggage compartments, and flight attendant service. The company expected that Delta and United would want them to continue to operate turboprops in markets where passenger load and other factors made the operation of a Bombardier Regional Jet impractical.

TheF uture

During the five years ending December 31, 2008, SkyWest, Inc., had grown at a compounded annual growth rate of 29.6 percent and the number of flights had increased from about 1,500 to 2,300. The company's growth had primarily come about through the addition of new partnerships and expansion of current ones to include new routes and additional departures. The acquisition of Atlantic Southeast Airlines in 2005 allowed SkyWest to expand geographically. Previously, the company had been mostly based in the western United States and had had little presence on the east coast. The acquisition of ASA gave SkyWest access to the east coast markets and comprehensive national coverage and greatly expanded the scope of operations by adding regional jets to their fleet and an anticipated $1 billion to operations.

The Chapter 11 filings of United and Delta created growth opportunities for SkyWest, Inc., as the majors began to outsource more of their routes during the restructuring of their operations. However, the bankruptcies also highlighted the risk inherent in contracts with major air carriers.[46] The company had attempted to expand its contractual relationships and had operated a few routes for Continental in the past and had made some overtures into establishing partnerships with low-cost carriers such as US Airways, Southwest, and Jet Blue. As of 2009, SkyWest had yet to attract permanent business from these carriers. Also, SkyWest had attempted an unsuccessful acquisition of ExpressJet in 2008. ExpressJet would have brought a large number of departures for Continental with it.

Considering the company's limited domestic opportunities, SkyWest had been undertaking efforts to expand its operations outside the United States. Internationally, SkyWest, Inc., was working with regional carriers in Europe, Latin America, and China. According to CEO Atkins, "Putting Europe aside since it is a mature market and we have a unique situation with which we are dealing, China, Brazil and Mexico are all high growth, emerging regional aviation markets. We questioned whether we should put in our portfolio some non-U.S. business. We've had people approach us for help in building their airline in Brazil or China. We'd help to train people, and, with our purchasing power, we can help to buy things at a lower rate. We would help organize them from a 10- to 20-aircraft operation to a major regional carrier in countries that really need a major regional carrier.[47] The opportunities afforded by international joint ventures are limited, however, by the 49 percent ownership limits that many foreign governments place on U.S. carriers."[48]

A consideration in further expansion for SkyWest was the "scope" clauses in major airline labor contracts with their pilots, as discussed earlier. Scope contracts placed limitations on the number and size of aircraft or flight activity that could be operated by a major airline's regional airline partners such as SkyWest Airlines or ASA. Since 2001, a number of major airlines (US Airways, Northwest Airlines, Delta, American Airlines, and United Airlines) had sought some removal of restrictions. Approval of scope clause liberalization could create opportunities for regional airlines to increase the numbers of routes flown in contract with major airline partners.[49]

Despite challenges and reduced revenues in the first five months of 2009, management expected that the company's (and the industry's) future was promising. SkyWest's combined revenue passenger miles had increased by 4.9 percent in June 2009, and its load factor had improved from 80.0 percent in June 2008 to 82.3 percent in June 2009.[50] Improved revenues for the second quarter had resulted in profits for JetBlue, US Airways, and Alaska Air Group, an indication that conditions in the industry might be poised to turn around. According to Dave Barger, CEO at JetBlue, June bookings had "started to pick back up."[51] Other observers did not expect a quick turnaround since business travel was still far below historical averages. Some analysts expected further consolidations and bankruptcies if the U.S. economy did not improve by year-end 2009. Such skeptical analysts believed continued bankruptcies would bring more chaos to an already chaotic industry environment.[52]

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Case 10

PepsiCo's Diversification Strategy in 2008

John E. Gamble
University of South Alabama

PepsiCo was the world's largest snack and beverage company, with 2007 net revenues of approximately $39.5 billion. The company's portfolio of businesses in 2008 included Frito-Lay salty snacks, Quaker Chewy granola bars, Pepsi soft drink products, Tropicana orange juice, Lipton Brisk tea, Gatorade, Propel, SoBe, Quaker Oatmeal, Cap'n Crunch, Aquafina, Rice-A-Roni, Aunt Jemima pancake mix, and many other regularly consumed products. Gatorade, Propel, Rice-A-Roni, Aunt Jemima, and Quaker Oats products had been added to PepsiCo's arsenal of brands through the $13.9 billion acquisition of Quaker Oats in 2001. The acquisition was the final component of a major portfolio restructuring initiative that began in 1997. Since the restructuring, the company had increased revenues and net income at annual rates of 7 percent and 12 percent, respectively. A summary of PepsiCo's financial performance is shown in Exhibit 1.

Through 2007, the company's top managers were focused on sustaining the impressive performance that had been achieved since its restructuring through strategies keyed to product innovation, close relationships with distribution allies, international expansion, and strategic acquisitions. Newly introduced products such as Gatorade G2, Tiger Woods signature sports drinks, and Quaker Simple Harvest multigrain hot cereal had accounted for 15–20 percent of all new growth in recent years. New product innovations that addressed consumer health and wellness concerns were the greatest contributors to the company's growth, with PepsiCo's better-for-you and good-for-you products accounting for 16 percent of its 2007 snack sales in North America, 70 percent of net beverage revenues in North America during 2007, and more than 50 percent of its 2007 sales of Quaker Oats products in North America. The company also increased the percentage of healthy snacks in markets outside North America since consumers in most developed countries wished to reduce their consumption of saturated fats, cholesterol, trans fats, and simple carbohydrates.

The company's Power of One retailer alliance strategy had been in effect for more than 10 years and was continuing to help boost PepsiCo's volume and identify new product formulations desired by consumers. Under the Power of One strategy, PepsiCo marketers and retailers collaborated in stores and during off-site summits to devise tactics to increase consumers' tendency to purchase more than one product offered by PepsiCo during a store visit. In addition, some of PepsiCo's most successful new products had been recommended by retailers.

PepsiCo's international sales had grown by 22 percent during 2007, but the company had many additional opportunities to increase sales in markets outside North America. The company

Exhibit 1

Financial Summary for PepsiCo Inc., 1998–2007 (in millions, except per share amounts)

	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998
Net revenue	$39,474	$35,137	$32,562	$29,261	$26,971	$25,112	$23,512	$20,438	$20,367	$22,348
Net income	5,599	5,065	4,078	4,212	3,568	3,000	2,400	2,183	2,050	1,993
Income per common share—basic, continuing operations	$3.38	$ 3.00	$2.43	$2.45	$2.07	$1.69	$1.35	$1.51	$1.40	$1.35
Cash dividends declared per common share	$1.42	$1.16	$1.01	$0.85	$0.63	$0.60	$0.58	$0.56	$0.54	$0.52
Total assets	$34,628	$29,930	$31,727	$27,987	$25,327	$23,474	$21,695	$18,339	$17,551	$22,660
Long-term debt	4,203	2,550	2,313	2,397	1,702	2,187	2,651	2,346	2,812	4,028

Source: PepsiCo 10-Ks, various years.

held large market shares in many international markets for beverages and salty snacks, but it had been relatively unsuccessful in making Quaker branded products available outside the United States. In 2006, 75 percent of Quaker Oats' international sales of $500 million was accounted for by just six countries. In addition, PepsiCo's international operations were much less profitable than its businesses operating in North America. While the operating profit margins of PepsiCo's international division had ranged from 13.4 to 15.6 percent between 2004 and 2007, operating profit margins for its Frito-Lay and North American beverage business ranged from 21.3 to 25 percent during the same time period. Quaker Foods' sales of Cap'n Crunch, Life cereal, Quaker oatmeal, Chewy granola bars, Aunt Jemima, and Rice-A-Roni produced the highest profit margins among all PepsiCo brands, with operating profits exceeding 30 percent each year between 2004 and 2007.

PepsiCo management developed a new organizational structure in 2008 to address the low relative profitability of its international operations and to produce even faster growth in international markets. The new structure that would place all brands sold in the United Kingdom, Europe, Asia, the Middle East, and Africa into a common division was expected to aid the company in its ability to capture strategic fits between its various brands and products. It was also quite possible that PepsiCo management needed to consider restructuring its lineup of snack and beverage businesses to improve overall profitability and reverse the downturn in its stock price that began in 2008. Exhibit 2 tracks PepsiCo's market performance between 1998 and October 2008.

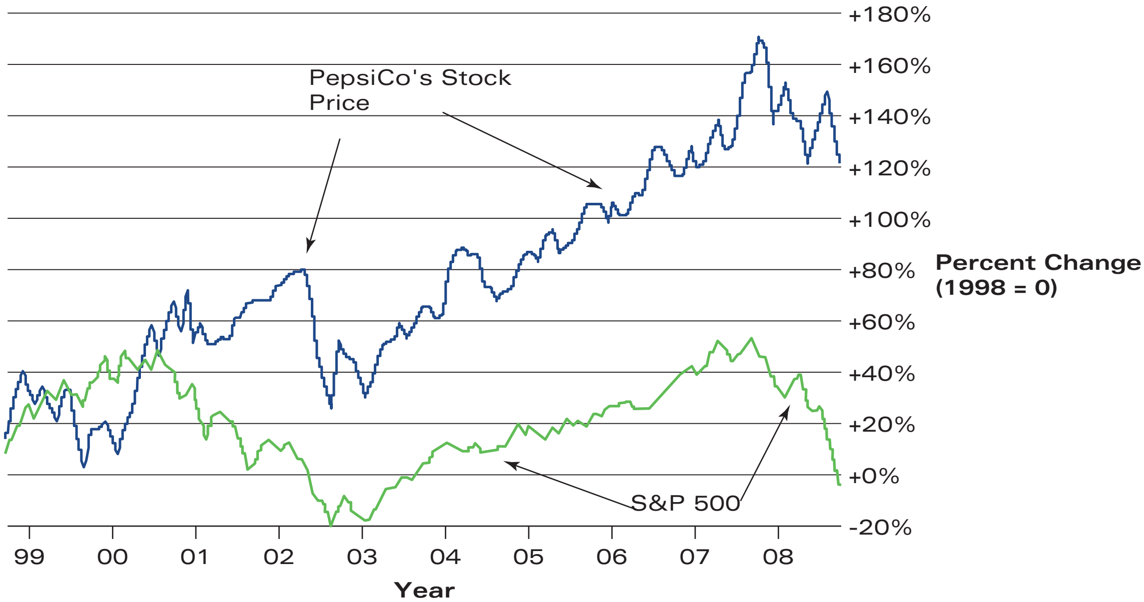
Company History

PepsiCo Inc. was established in 1965 when Pepsi-Cola and Frito-Lay shareholders agreed to a merger between the salty snack icon and soft drink giant. The new company was founded with annual revenues of $510 million and such well-known brands as Pepsi-Cola, Mountain Dew, Fritos, Lay's, Cheetos, Ruffles, and Rold Gold. PepsiCo's roots can be traced to 1898, when New Bern, North Carolina, pharmacist Caleb Bradham created the formula for a carbonated beverage he named Pepsi-Cola. The company's salty-snack business began in

EXHIBIT 2 **Monthly Performance of PepsiCo Inc.'s Stock Price, 1998 to March 2008**

(a) Trend in PepsiCo, Inc.'s Common Stock Price

(b) Performance of PepsiCo, Inc.'s Stock Price versus the S&P 500 Index



1932 when Elmer Doolin of San Antonio, Texas, began manufacturing and marketing Fritos corn chips and Herman Lay started a potato chip distribution business in Nashville, Tennessee. In 1961, Doolin and Lay agreed to a merger between their businesses to establish the Frito-Lay Company.

During its first five years as a snack and beverage company, PepsiCo introduced new products such as Doritos and Funyuns; entered markets in Japan and Eastern Europe; and opened, on average, one new snack food plant per year. By 1971, PepsiCo had more than doubled its revenues to reach $1 billion. The company began to pursue growth through acquisitions outside snacks and beverages as early as 1968, but its 1977 acquisition of Pizza Hut significantly shaped the strategic direction of PepsiCo for the next 20 years. The acquisitions of Taco Bell in 1978 and Kentucky Fried Chicken in 1986 created a business portfolio described by Wayne Calloway (PepsiCo's CEO between 1986 and 1996) as a balanced three-legged stool. Calloway believed the combination of snack foods, soft drinks, and fast food offered considerable cost-sharing and skills-transfer opportunities, and he routinely shifted managers between the company's three divisions as part of the company's management development efforts.

PepsiCo also strengthened its portfolio of snack foods and beverages during the 1980s and 1990s with acquisitions of Mug root beer, 7UP International, Smartfood ready-to-eat popcorn, Walker's Crisps (UK), Smith's Crisps (UK), Mexican cookie company, Gamesa, and SunChips. Calloway also added quick-service restaurants Hot-n-Now in 1990, California Pizza Kitchens in 1992, and East Side Mario's, D'Angelo Sandwich Shops, and Chevy's Mexican Restaurants in 1993. The company expanded beyond carbonated beverages with a 1992 agreement with Ocean Spray to distribute single-serving juices, the introduction of Lipton ready-to-drink teas in 1993, and the introduction of Aquafina bottled water and Frappuccino ready-to-drink coffees in 1994.

By 1996, it had become clear to PepsiCo management that the potential strategic-fit benefits existing between restaurants and PepsiCo's core beverage and snack businesses were difficult to capture. In addition, any synergistic benefits achieved were more than offset by the fast-food industry's fierce price competition and low profit margins. In 1997, CEO Roger Enrico spun off the company's restaurants as an independent, publicly traded company to focus PepsiCo on food and beverages. Soon after the spin-off of PepsiCo's fast-food restaurants was completed, Enrico acquired Cracker Jack, Tropicana, Smith's Snackfood Company in Australia, SoBe teas and alternative beverages, Tasali Snack Foods (the leader in the Saudi Arabian salty snack market), and the Quaker Oats Company.

TheQ uakerO ats Acquisition

At $13.9 billion, Quaker Oats was PepsiCo's largest acquisition and gave it the number one brand of oatmeal in the United States, with a 60+ percent category share; the leading brand of rice cakes and granola snack bars; and other well-known grocery brands such as Cap'n Crunch, Rice-A-Roni, and Aunt Jemima. However, Quaker's most valuable asset in its arsenal of brands was Gatorade.

Gatorade was developed by University of Florida researchers in 1965 but was not marketed commercially until the formula was sold to Stokely–Van Camp in 1967. When Quaker Oats acquired the brand from Stokely–Van Camp in 1983, Gatorade gradually made a transformation from a regionally distributed product with annual sales of $90 million to a $2 billion powerhouse. Gatorade was able to increase sales by more than 10 percent annually during the 1990s, with no new entrant to the isotonic beverage category posing a serious threat to the brand's dominance. PepsiCo, Coca-Cola, France's Danone Group, and Swiss food giant Nestlé all were attracted to Gatorade because of its commanding market share and because of the expected growth in the isotonic sports beverage category. PepsiCo became the successful bidder for Quaker Oats and Gatorade with an agreement struck in December 2000 but would not receive U.S. Federal Trade Commission (FTC) approval until August 2001. The FTC's primary concern over the merger was that Gatorade's inclusion in PepsiCo's portfolio of snacks and beverages might give the company too much leverage in negotiations with convenience stores and ultimately force smaller snack food and beverage companies out of convenience store channels. In its approval of the merger, the FTC stipulated that Gatorade could not be jointly distributed with PepsiCo's soft drinks for 10 years.

Acquisitions after 2001

After the completion of the Quaker Oats acquisition in August 2001, the company focused on integration of Quaker Oats' food, snack, and beverage brands into the PepsiCo portfolio. The company made a number of "tuck-in" acquisitions of small, fast-growing food and beverage companies in the United States and internationally to broaden its portfolio of brands. Tuck-in acquisitions in 2006 included Stacy's bagel and pita chips, Izze carbonated beverages, Duyvis nuts (Netherlands), and Star Foods (Poland). Acquisitions made during 2007 included Naked Juice fruit beverages, Sandora juices (Ukraine), Bluebird snacks (New Zealand), Penelopa nuts and seeds (Bulgaria), and Lucky snacks (Brazil). The company also entered into a joint venture with the Strauss Group in 2007 to market Sabra, the top-selling and fastest-growing brand of hummus in the United States and Canada.

PepsiCo's acquisitions in 2007 totaled $1.3 billion, whereas the company had made acquisitions totaling $522 million in 2006 and $1.1 billion in 2005. The combination of acquisitions and the strength of PepsiCo's core snacks and beverages business allowed the company's revenues to increase from approximately $20 billion in 2000 to more than $39.5 billion in 2007. Exhibit 3 presents PepsiCo's consolidated statements of income for 2005–2007. The company's balance sheets for 2005–2007 are provided in Exhibit 4. The company's calculation of management operating cash flow for 2004–2007 is shown in Exhibit 5.

Building Shareholder Value in 2008

Three people had held the position of CEO since the company began its portfolio restructuring in 1997. Even though Roger Enrico was the chief architect of the business lineup as it stood in 2007, his successor, Steve Reinemund, and the company's CEO in 2007, Indra Nooyi, were both critically involved in the restructuring. Nooyi joined PepsiCo in 1994 and developed a reputation as a tough negotiator who engineered the 1997 spin-off of Pepsi's restaurants, spearheaded the 1998 acquisition of Tropicana, and played a critical role in the 1999 initial public offering of Pepsi's bottling operations. After being promoted to chief financial officer, Nooyi was also highly involved in the

Exhibit 3

PepsiCo Inc.'s Consolidated Statements of Income, 2005–2007 (in millions, except per share amounts)

	2007	2006	2005
Net revenue	$39,474	$35,137	$32,562
Cost of sales	18,038	15,762	14,176
Selling, general, and administrative expenses	14,208	12,774	12,314
Amortization of intangible assets	58	162	150
Operating profit	7,170	6,439	5,922
Bottling equity income	560	616	557
Interest expense	(224)	(239)	(256)
Interest income	125	173	159
Income before income taxes	7,631	6,989	6,382
Provision for income taxes	1,973	1,347	2,304
Net income	$ 5,658	$ 5,642	$ 4,078
Net income per common share—basic	$ 3.48	$ 3.42	$ 2.43
Net income per common share—diluted	$ 3.41	$ 3.34	$ 2.39

Source: PepsiCo Inc., 2007 10-K report.

Exhibit 4

PepsiCo Inc.'s Consolidated Balance Sheets, 2005–2007 (in millions, except per share amounts)

	DECEMBER 29, 2007	DECEMBER 30, 2006	DECEMBER 31, 2005
Assets			
Current assets			
Cash and cash equivalents	$ 910	$ 1,651	$ 1,716
Short-term investments	1,571	1,171	3,166
Accounts and notes receivable, net	4,389	3,725	3,261
Inventories	2,290	1,926	1,693
Prepaid expenses and other current assets	991	657	618
Total current assets	$10,151	$ 9,130	$10,454
Property, plant and equipment, net	11,228	9,687	8,681
Amortizable intangible assets, net	796	637	530
Goodwill	5,169	4,594	4,088
Other nonamortizable intangible assets	1,248	1,212	1,086
Nonamortizable intangible assets	6,417	5,806	5,174
Investments in noncontrolled affiliates	4,354	3,690	3,485
Other assets	1,682	980	3,403
Total assets	$34,628	$29,930	$31,727
Liabilities and Shareholders' Equity			
Current liabilities			
Short-term obligations	—	$ 274	$ 2,889
Accounts payable and other current liabilities	7,602	6,496	5,971
Income taxes payable	151	90	546
Total current liabilities	7,753	6,860	9,406
Long-term debt obligations	4,203	2,550	2,313
Other liabilities	4,792	4,624	4,323
Deferred income taxes	646	528	1,434
Total liabilities	$17,394	$14,562	$17,476
Commitments and contingencies			
Preferred stock, no par value	41	41	41
Repurchased preferred stock	(132)	(120)	(110)
Common shareholders' equity			
Common stock, par value $1\frac{2}{3}$¢ per share (issued 1,782 shares)	30	30	30
Capital in excess of par value	450	584	614
Retained earnings	28,184	24,837	21,116
Accumulated other comprehensive loss	(952)	(2,246)	(1,053)
	27,712	23,205	20,707
Less: repurchased common stock, at cost (144 and 126 shares, respectively)	(10,387)	(7,758)	(6,387)
Total common shareholders' equity	$17,325	$15,447	$14,320
Total liabilities and shareholders' equity	$34,628	$29,930	$31,727

Source: PepsiCo Inc., 2007 10-K report.

2001 acquisition of Quaker Oats. Nooyi was selected as the company's CEO upon Reinemund's retirement in October 2006. Nooyi had emigrated to the United States in 1978 to attend Yale's Graduate School of Business and worked with Boston Consulting Group, Motorola, and Asea Brown Boveri before arriving at PepsiCo in 1994.

In 2008, PepsiCo's corporate strategy had diversified the company into salty and sweet

Exhibit 5

Net Cash Provided by PepsiCo's Operating Activities, 2004–2007 (in millions)

	2007	2006	2005	2004
Net cash provided by operating activities	$6,934	$6,084	$5,852	$5,054
Capital spending	(2,430)	(2,068)	(1,736)	(1,387)
Sales of property, plant and equipment	47	49	88	38
Management operating cash flow	$4,551	$4,065	$4,204	$3,705

Source: PepsiCo Inc., 2007 10-K report.

snacks, soft drinks, orange juice, bottled water, ready-to-drink teas and coffees, purified and functional waters, isotonic beverages, hot and ready-to-eat breakfast cereals, grain-based products, and breakfast condiments. Most PepsiCo brands had achieved number one or number two positions in their respective food and beverage categories through strategies keyed to product innovation, close relationships with distribution allies, international expansion, and strategic acquisitions. A relatively new element of PepsiCo's corporate strategy was product reformulations to make snack foods and beverages healthier. The company believed that its efforts to develop "good-for-you" or "better-for-you" products would create growth opportunities from the intersection of business and public interests.

The company was organized into four business divisions, which all followed the corporation's general strategic approach. Frito-Lay North America manufactured, marketed, and distributed such snack foods as Lay's potato chips, Doritos tortilla chips, Cheetos cheese snacks, Fritos corn chips, Quaker Chewy granola bars, Grandma's cookies, and Smartfood popcorn. The PepsiCo Beverages North America beverage business manufactured, marketed, and sold beverage concentrates, fountain syrups, and finished goods under such brands as Pepsi, Gatorade, Tropicana, Lipton, Dole, and SoBe. PepsiCo International manufactured, marketed, and sold snacks and beverages in approximately 200 countries outside the United States. Quaker Foods North America manufactured and marketed cereals, rice and pasta dishes, and other food items that were sold in supermarkets. A full listing of Frito-Lay snacks, PepsiCo beverages, and Quaker Oats products is presented in Exhibit 6. Selected financial information for PepsiCo's four divisions is presented in Exhibit 7.

Frito-LayN orth America

In 2007, Frito-Lay brands accounted for 29 percent of the PepsiCo's total revenues and 36 percent of the company's operating profits. Frito-Lay also accounted for more than 70 percent of the salty snack food industry's total sales in the United States, which had grown at low single-digit rates annually since 2000 to reach $15.9 billion in 2008. Three key trends that were shaping the industry were convenience, a growing awareness of nutritional content of snack foods, and indulgent snacking. A product manager for a regional snack producer explained, "Many consumers want to reward themselves with great-tasting, gourmet flavors and styles. . . . The indulgent theme carries into seasonings as well. Overall, upscale restaurant-influenced flavor trends are emerging to fill consumers' desires to escape from the norm and taste snacks from a wider, often global, palate."[1] Most manufacturers had developed new flavors of salty snacks such as jalapeno and cheddar tortilla chips and pepper jack potato chips to attract the interest of indulgent snackers. Manufacturers had also begun using healthier oils when processing chips

Exhibit 6

PepsiCo Inc.'s Snack, Beverage, and Quaker Oats Brands, 2008

FRITO-LAY BRANDS

- Lay's potato chips
- Maui Style potato chips
- Ruffles potato chips
- Doritos tortilla chips
- Tostitos tortilla chips
- Santitas tortilla chips
- Fritos corn chips
- Cheetos cheese flavored snacks
- Rold Gold pretzels and snack mix
- Funyuns onion flavored rings
- Go Snacks
- SunChips multigrain snacks
- Sabritones puffed wheat snacks
- Cracker Jack candy-coated popcorn
- Chester's popcorn
- Grandma's cookies
- Munchos potato crisps
- Smartfood popcorn
- Baken-ets fried pork skins
- Oberto meat snacks
- Rustler's meat snacks
- Churrumais fried corn strips
- Frito-Lay nuts
- Frito-Lay, Ruffles, Fritos, and Tostitos dips and salsas
- Frito-Lay, Doritos, and Cheetos snack crackers
- Fritos, Tostitos, Ruffles, and Doritos snack kits
- Hickory Sticks
- Hostess Potato
- Lay's Stax potato crisps
- Miss Vickie's potato chips
- Munchies snack mix
- Stacy's pita chips
- Flat Earth Fruit and Vegetable Chips
- Sabra hummus

Outside North America

- Bocabits wheat snacks
- Crujitos corn snacks
- Fandangos corn snacks

PEPSICO BEVERAGE BRANDS

- Pepsi-Cola
- Mountain Dew
- Mountain Dew AMP energy drink
- Mug root beer
- Sierra Mist
- Slice
- Lipton Brisk (partnership)
- Lipton Iced Tea (partnership)
- Dole juices and juice drinks (license)
- FruitWorks juice drinks
- Aquafina purified drinking water
- Frappuccino ready-to-drink coffee (partnership)
- Starbucks DoubleShot (partnership)
- SoBe juice drinks, dairy, and teas
- SoBe energy drinks (No Fear and Adrenaline Rush)
- Gatorade
- Propel
- Tropicana
- Tropicana Twister
- Tropicana Smoothie
- Izze soft drinks
- Naked Juice

Outside North America

- Mirinda
- 7UP
- Pepsi
- Kas
- Teem
- Manzanita Sol
- Paso de los Toros
- Fruko
- Evervess
- Yedigun
- Shani
- Fiesta
- D&G (license)
- Mandarin (license)
- Radical Fruit
- Tropicana Touche de Lait
- Alvalle gazpacho fruit juices and vegetable juices

QUAKER OATS BRANDS

- Quaker Oatmeal
- Cap'n Crunch cereal
- Life cereal
- Quaker 100% Natural cereal
- Quaker Squares cereal
- Quisp cereal
- King Vitaman cereal
- Quaker Oh's! Cereal
- Mother's cereal
- Quaker grits
- Quaker Oatmeal-to-Go
- Aunt Jemima mixes & syrups
- Quaker rice cakes
- Quaker rice snacks (Quakes)
- Quaker Chewy granola bars
- Quaker Dipps granola bars
- Rice-A-Roni side dishes
- PastaRoni side dishes
- Near East side dishes
- Puffed Wheat
- Harvest Crunch cereal
- Quaker Baking Mixes
- Spudz snacks
- Crisp'ums baked crisps
- Quaker Fruit & Oatmeal bars
- Quaker Fruit & Oatmeal Bites
- Quaker Fruit and Oatmeal Toastables
- Quaker Soy Crisps
- Quaker Bakeries

Outside North America

- FrescAvena beverage powder
- Toddy chocolate powder
- Toddynho chocolate drink
- Coqueiro canned fish
- Sugar Puffs cereal
- Puffed Wheat
- Cruesli cereal
- Hot Oat Crunch cereal
- Quaker Oatso Simple hot cereal
- Scott's Porage Oats

continued

Exhibit 6 (continued)

FRITO-LAY BRANDS

- Hamka's snacks
- Niknaks cheese snacks
- Quavers potato snacks
- Sabritas potato chips
- Smiths potato chips
- Walkers potato crisps
- Gamesa cookies
- Doritos Dippas
- Sonric's sweet snacks
- Wotsits corn snacks
- Red Rock Deli
- Kurkure
- Smiths Sensations
- Cheetos Shots
- Quavers Snacks
- Bluebird Snacks
- Duyvis Nuts
- Lucky snacks
- Penelopa nuts and seeds

PEPSICO BEVERAGE BRANDS

- Tropicana Season's Best juices and juice drinks
- Loóza juices and nectars
- Copella juices
- Frui'Vita juices
- Sandora juices

QUAKER OATS BRANDS

- Scott's So Easy Oats
- Quaker bagged cereals
- Quaker Mais Sabor
- Quaker Oats
- Quaker oat flour
- Quaker Meu Mingau
- Quaker cereal bars
- Quaker Oatbran
- Corn goods
- Magico chocolate powder
- Quaker Vitaly Cookies
- 3 Minutos Mixed Cereal
- Quaker Mágica
- Quaker Mágica con Soja
- Quaker Pastas
- Quaker Frut

Source: Pepsico.com.

Exhibit 7

Selected Financial Data for PepsiCo Inc.'s Business Segments, 2004–2007 (in millions)

	2007	2006	2005	2004
Net Revenues				
Frito-Lay North America	$11,586	$10,844	$10,322	$ 9,560
PepsiCo Beverages North America	10,230	9,565	9,146	8,313
Pepsi International	15,798	12,959	11,376	9,862
Quaker Foods North America	1,860	1,769	1,718	1,526
Total division	39,474	35,137	32,562	29,261
Corporate	—	—	—	—
Total	$39,474	$35,137	$32,562	$29,261
Operating Profit				
Frito-Lay North America	$2,845	$2,615	$2,529	$2,389
PepsiCo Beverages North America	2,188	2,055	2,037	1,911
Pepsi International	2,322	2,016	1,661	1,323
Quarker Foods North America	568	554	537	475
Total division	7,923	7,240	6,764	6,098
Corporate	(753)	(738)	(780)	(689)
Total	$7,170	$6,502	$5,984	$5,409

continued

Exhibit 7 (continued)

	2007	2006	2005	2004
Capital Expenditures				
Frito-Lay North America	$ 624	$ 499	$ 512	$ 469
PepsiCo Beverages North America	430	492	320	265
Pepsi International	1,108	835	667	537
Quaker Foods North America	41	31	31	33
Total division	2,203	1,857	1,530	1,304
Corporate	227	211	206	83
Total	$ 2,430	$ 2,068	$ 1,736	$ 1,387
Total Assets				
Frito-Lay North America	$ 6,270	$ 5,969	$ 5,948	$ 5,476
PepsiCo Beverages North America	7,130	6,567	6,316	6,048
Pepsi International	14,747	11,274	9,983	8,921
Quaker Foods North America	1,002	1,003	989	978
Total division	29,149	25,110	23,482	21,423
Corporate	2,124	1,739	5,331	3,569
Investments in bottling affiliates	3,355	3,378	3,160	2,995
Total	$34,628	$29,930	$31,727	$27,987
Depreciation and Other Amortization				
Frito-Lay North America	$ 437	$ 432	$ 419	$ 420
PepsiCo Beverages North America	302	282	264	258
Pepsi International	564	478	420	382
Quaker Foods North America	34	33	34	36
Total division	1,337	1,225	1,137	1,096
Corporate	31	19	21	21
Total	$ 1,368	$ 1,244	$ 1,158	$ 1,117
Amortization of Other Intangible Assets				
Frito-Lay North America	$ 9	$ 9	$ 3	$ 3
PepsiCo Beverages North America	11	77	76	75
Pepsi International	38	76	71	68
Quaker Foods North America	—	—	—	1
Total division	58	162	150	147
Corporate	—	—	—	—
Total	$ 58	$ 162	$ 150	$147

Source: PepsiCo Inc., 2007 10-K report.

and had expanded lines of baked and natural salty snacks to satisfy the demands of health-conscious consumers. Snacks packaged in smaller bags also addressed overeating concerns and were additionally convenient to take along on an outing. In 2008 Frito-Lay owned the top-selling chip brand in each U.S. salty snack category and held more than a two-to-one lead over the next largest snack food maker in the United States. The following table presents shares of the U.S. convenience food market for leading manufacturers in 2006. Convenience foods included both salty and sweet snacks such as chips, pretzels, ready-to-eat popcorn, crackers, dips, snack nuts and seeds, candy bars, and cookies.

MANUFACTURER	MARKET SHARE
PepsiCo	21%
Kraft Foods	12
Hershey	9
Kellogg	6
Master Foods	5
General Mills	2
Procter & Gamble	1
Private label	7
Others	37
Total	100%

Note: The share information shown above excludes data from certain retailers such as Walmart that do not report data to Information Resources Inc. and ACNielsen Corporation.

Source: PepsiCo Inc., 2006 10-K report.

Frito-Lay North America's (FLNA) revenues increased 7 percent during 2007 as a result of double-digit growth in sales of SunChips, Quaker rice cakes, and multipacks of other products. FLNA's better-for-you and good-for-you snacks also grew at double-digit rates during 2007 and represented 16 percent of the division's total revenue. In 2008, improving the performance of the division's core salty brands and further developing health and wellness products were key strategic initiatives. The company had eliminated trans fats from all Lay's, Fritos, Ruffles, Cheetos, Tostitos, and Doritos varieties and was looking for further innovations to make its salty snacks more healthy. The company had introduced Lay's Classic potato chips, which were cooked in sunflower oil and retained Lay's traditional flavor but contained 50 percent less saturated fat. The company had also developed new multigrain and flour tortilla Tostitos varieties that appealed to indulgent snackers and were healthier than traditional Tostitos. Other new indulgent Doritos flavors included Fiery Habanero and Blazin' Buffalo & Ranch. FLNA had also expanded the number of flavors of SunChips to sustain the brand's double-digit growth. New SunChips flavors included Garden Salsa and Cinnamon Crunch. SunChips were also introduced in 100-calorie minipacks and 20-bag multipacks.

PepsiCo's 2006 acquisition of Flat Earth fruit and vegetable snacks offered an opportunity for the company to exploit consumers' desires for healthier snacks and address a deficiency in most diets. Americans, on average, consumed only about 50 percent of the U.S. Department of Agriculture's recommended daily diet of fruits and vegetables. Flat Earth's baked vegetable crisps (Farmland Cheddar, Tangy Tomato Ranch, Garlic & Herb Field) and baked fruit crisps (Peach Mango Paradise, Apple Cinnamon Grove, and Wild Berry Patch) were launched in 2007. Other good-for-you snacks included Stacy's pita chips, which was also acquired in 2006, and Quaker Chewy granola bars. In 2008, Stacy's pita chips came in 15 varieties, including Multigrain, Soy Thin Sticky Bun, Cinnamon Sugar, Whole Wheat, and Texarkana Hot. Quaker Chewy granola bars had achieved a number two rank in the segment, with a 25 percent market share in 2006. Some of the success of Quaker Chewy granola products was related to product innovations such as reduced-calorie oatmeal-and-raisin bars. PepsiCo Beverages North America also distributed Quaker rice cakes, which had added chocolate-drizzled and multigrain varieties in 2007.

PepsiCo Beverages North America

PepsiCo was the largest seller of liquid refreshments in the United States, with a 26 percent share of the market in 2006. Coca-Cola was the second largest nonalcoholic beverage producer, with a 23 percent market share. Cadbury Schweppes and Nestlé were the third and fourth largest beverage sellers in 2006, with market shares of 10 percent and 8 percent, respectively. Like Frito-Lay, PepsiCo's beverage business contributed greatly to the corporation's overall profitability and free cash flows. In 2007, PepsiCo Beverages North America (PBNA) accounted for 28 percent of the corporation's total revenues and 31 percent of its profits. Revenues for PBNA had increased by 7 percent annually between 2006 and 2007 as the company broadened its line of noncarbonated beverages like Gatorade, Tropicana fruit juices, Lipton ready-to-drink tea, Propel, Aquafina, Dole fruit drinks, Starbucks cold coffee drinks, and SoBe. Carbonated soft drinks were the most-consumed type of beverage in the United States, with a 48 percent of share of the total beverage market, but carbonated soft drink volume declined by 2.6 percent in 2007 as consumers searched for healthier beverage choices. In contrast, flavored and enhanced water products grew by 30.6 percent, energy drinks grew by 24.7 percent, ready-to-drink tea grew by 15 percent, and bottled water grew by 6.9 percent between 2006 and 2007. The size and volume share of the U.S. beverage industry by beverage category for 2005 through 2007 is presented in Exhibit8 .

PEPSICO'S CARBONATED SOFT DRINKS BUSINESS During the mid-1990s, it looked as if Coca-Cola would dominate the soft drink industry, with every Pepsi-Cola brand except Mountain Dew losing market share to Coca-Cola's brands. Coca-Cola's CEO at the time, Roberto Goizueta, had stated that the company's strategic intent was to control 50 percent of the U.S. cola market by 2000 and seemed convinced PepsiCo could do little to stop the industry leader. Goizueta summed up his lack of concern about Pepsi as a key rival in an October 28, 1996, *Fortune* article entitled "How Coke Is Kicking Pepsi's Can" by saying, "As they've become less relevant, I don't need to look at them very much anymore."

PepsiCo's management engineered a comeback in the late 1990s and early 2000s by launching new brands like Sierra Mist and focusing on strategies to improve local distribution. Among Pepsi's most successful strategies to build volume and share in soft drinks was its "Power of One" strategy, which attempted to achieve the synergistic benefits of a combined Pepsi-Cola and Frito-Lay envisioned by shareholders of the two companies in 1965. The Power of One strategy called for supermarkets to place Pepsi and Frito-Lay products side by side on shelves. In 2006, PepsiCo added "Innovation Summits" to its Power of One program whereby retailers could share their views on consumer shopping and eating habits. PepsiCo used the information gleaned from the summits in developing new products like SoBe Life Water and Lay's potato chips cooked in sunflower oil. The summits, which continued into 2007, also helped identify PepsiCo supply chain inefficiencies that affected retailers. PepsiCo managers and retailers collaborated during one Innovation

Exhibit 8

Volume Size and Share of the U.S. Liquid Refreshment Beverage Market by Segment, 2005–2007

	VOLUME BY BEVERAGE CATEGORY (MILLIONS OF GALLONS)			VOLUME SHARE		
BEVERAGE CATEGORY	2005	2006	2007	2005	2006	2007
Carbonated soft drinks	15,271.6	15,103.6	14,707.4	52.9%	50.1%	48.1%
Bottled water*	7,537.1	8,253.1	8,822.4	26.1	27.4	28.9
Fruit beverages	4,119.0	4,020.1	3,899.5	14.3	13.3	12.8
Isotonic sports drinks	1,207.5	1,322.0	1,355.1	4.2	4.4	4.4
Ready-to-drink tea	555.9	760.9	875.1	1.9	2.5	2.9
Flavored and enhanced water	—	418.5	546.5	—	1.4	1.8
Energy drinks	152.5	242.7	302.6	0.5	0.8	1.0
Ready-to-drink coffee	38.9	44.5	45.1	0.1	0.1	0.1
Total	28,882.5	30,165.8	30,553.7	100.0%	100.0%	100.0%

*Excludes flavored and enhanced water after 2005.

Source: Beverage Marketing Corporation.

Summit to develop new shipping procedures that reduced stock-outs in retailers' stores.

PepsiCo's primary focus in soft drink innovation was directed toward improving the nutritional properties of soft drinks. The company was attempting to develop new types of sweeteners that would lower the calorie content of nondiet drinks. The company also hoped its 2006 acquisition of Izze lightly carbonated sparkling fruit drinks would prove popular with health-conscious consumers. Tava was an additional calorie-free, caffeine-free, better-for-you carbonated beverage that PBNA launched in the United States in 2007. Even though PepsiCo strengthened its position in the U.S. carbonated soft drink industry, its 31.1 percent market share during 2007 was considerably less than Coca-Cola's 2007 market share of 41.6 percent.

PEPSICO'S NONCARBONATED BEVERAGE BRANDS Although carbonated beverages made up the largest percentage of PBNA's total beverage volume, much of the division's growth was attributable to the success of its noncarbonated beverages. In 2007, total revenue for the division increased by 7 percent, which was driven by a 5 percent increase in noncarbonated beverages and the contribution of new acquisitions. Carbonated soft drink volume declined by 3 percent during 2007.

Aquafina was the number one brand of bottled water in the United States and grew by 6.9 percent between 2006 and 2007. Bottled water was a particularly attractive segment for PepsiCo since bottled water consumption in the United States had increased from 4.6 billion gallons in 1999 to 8.8 billion gallons in 2007. PepsiCo's Frappuccino ready-to-drink (RTD) coffee and Lipton RTD teas made it the leader in the RTD tea and RTD coffee categories as well. The RTD tea category grew by 15 percent between 2006 and 2007, while RTD coffees grew by just over 1 percent during 2007. PepsiCo's SoBe Essential Energy and SoBe Adrenaline Rush drinks held a negligible share of the energy drink market, with Red Bull accounting for 40 percent of industry sales in 2007. Red Bull was produced and marketed by the privately held Red Bull GmbH, of Austria. Hansen Natural Corporation's Monster energy drink and Coca-Cola's Full Throttle energy drink accounted for approximately 30 percent of industry sales in 2007.

In 2008, PBNA's Propel Fitness Water was the leading brand of functional water. In 2006, the company had also introduced SoBe Life Water and functional versions of Aquafina. The product lines for its water business were developed around customer type and lifestyle. Propel was a flavor- and vitamin-enriched water marketed to physically active consumers, while Life Water was a vitamin-enhanced water marketed to image-driven consumers. The company targeted mainstream water consumers with unflavored Aquafina, Aquafina FlavorSplash (offered in four flavors), and Aquafina Sparkling (a zero-calorie, lightly carbonated citrus- or berry-flavored water). Aquafina Alive, launched in 2007, included vitamins and natural fruit juices. The company's strategy involved offering a continuum of healthy beverages from unflavored Aquafina to nutrient-rich Gatorade. In 2007, Gatorade, Propel, and Aquafina were all number one in their categories, with market shares of 76 percent, 40 percent, and approximately 15 percent, respectively.

Gatorade's volume had grown by 21 percent in 2005 and by 12 percent in 2006 to reach sales of over $3 billion. Gatorade's impressive growth had come about through the introduction of new flavors and formulations such as the lower-calorie G2 and the Tiger Woods signature Gatorade sub-brand. Volume growth was also attributable to new container sizes and designs, new multipacks, world-class advertising, and added points of distribution. Analysts believed that Gatorade could achieve even stronger performance once the U.S. Federal Trade Commission's 10-year prohibition on bundled beverage contracts with retailers and joint Gatorade/soft drink distribution came to an end. Gatorade's broker-distribution system also allowed Tropicana and Lipton RTD teas to double sales volume between the 2001 acquisition of Quaker Oats and year-end 2006. PepsiCo's 39.5 percent market share in RTD teas in 2007 was nearly four times greater than the 10.7 percent share held by Coca-Cola's Nestea RTD tea. Tropicana was the number one brand in the $3 billion orange juice industry, with an approximate 30 percent market share in 2007. Coca-Cola's Minute Maid brand of orange juice held a 25 percent market share in 2007. The combined sales of PBNA's better-for-you and good-for-you beverages made up 70 percent of the division's net revenue in both 2006 and 2007.

PepsiCo International

All PepsiCo snacks, beverages, and food items sold outside North America were included in the company's PepsiCo International division. International snack volume grew by 9 percent in 2007, with double-digit growth in emerging markets such as Russia, the Middle East, and Turkey. Beverage volume in international markets increased by 8 percent during 2007, with the fastest growth occurring in the Middle East, China, and Pakistan. Volume gains, along with acquisitions in Europe, the Middle East, Africa, New Zealand, and Brazil, allowed the division's revenues and operating profits to increase by 22 percent and 15 percent, respectively, between 2006 and 2007. PepsiCo's 2007 acquisitions in international markets were expected to boost 2008 revenues by more than $1 billion.

PEPSICO'S SALE OF BEVERAGES IN INTERNATIONAL MARKETS PepsiCo also found that it could grow international sales through its Power of One strategy. A PepsiCo executive explained how the company's soft drink business could gain shelf space through the strength of Frito-Lay's brands: "You go to Chile, where Frito-Lay has over 90 percent of the market, but Pepsi is in lousy shape. Frito-Lay can help Pepsi change that."[2] PepsiCo's market share in carbonated soft drinks in its strongest international markets during 2006 is presented in the following table:

COUNTRY/REGION	PEPSICO'S CARBONATED SOFT DRINK MARKET SHARE
Middle East	75% +
India	49
Thailand	49
Egypt	47
Venezuela	42
Nigeria	38
China	36
Russia	24

Source: PepsiCo Investor Presentation by Mike White, CEO PepsiCo International, 2006.

PepsiCo International management believed further opportunities in other international markets existed. In 2007, the average consumption of carbonated soft drinks in the United States was 60 servings per month, while the average consumption of carbonated soft drinks in other developed countries was 23 servings per month and in developing countries was six servings per month. The company also saw a vast opportunity for sales growth in the $70 billion market for noncarbonated beverages in international markets. In 2006, PepsiCo International recorded less than $1 billion in noncarbonated beverage sales outside North America. The company was rapidly rolling out Tropicana to international markets and had acquired two international juice brands to capture a larger share of the $37 billion international markets for juice drinks. Also, PepsiCo was making Gatorade available in more international markets to capture a share of the $5 billion isotonic sports drink market outside the United States. Sales of Gatorade in Latin America more than doubled between 2001 and 2006, giving the sports drink a 72 percent market share in the entire Latin American region in 2006. PepsiCo International was also moving into new markets with Lipton RTD tea, gaining a share of the $15 billion international RTD tea market. In 2007, Gatorade was available in 42 international markets, Tropicana was in 27 country markets outside North America, and Lipton was sold in 27 international markets. Tropicana was the number one juice brand in Europe and had achieved a

100 percent increase in sales in the region between 2001 and 2006. By 2012, PepsiCo planned to launch Gatorade in 15 additional country markets, Tropicana in 20 new markets, and Lipton in five new international markets.

PepsiCo had moved somewhat slowly into international bottled water markets, with its most notable effort occurring in Mexico. In 2002, PepsiCo's bottling operations acquired Mexico's largest Pepsi bottler, Pepsi-Gemex SA de CV, for $1.26 billion. Gemex not only bottled and distributed Pepsi soft drinks in Mexico but was also Mexico's number one producer of purified water. After its acquisition of Gemex, PepsiCo shifted its international expansion efforts to bringing Aquafina to selected emerging markets in Eastern Europe, the Middle East, and Asia. In 2006, Aquafina was the number one brand of bottled water in Russia and Vietnam, and the number two brand in Kuwait.

PEPSICO'S SALES OF SNACK FOODS IN INTERNATIONAL MARKETS Frito-Lay was the largest snack chip company in the world, with sales of approximately $7 billion outside the United States and a 40+ percent share of the international salty snack industry in 2006. Frito-Lay held commanding shares of the market for salty snacks in many country markets. The following table presents PepsiCo's salty snack market share in selected countries in 2006:

COUNTRY	PEPSICO'S SALTY SNACK MARKET SHARE
Mexico	75%
Holland	59
South Africa	57
Australia	55
Brazil	46
India	46
United Kingdom	44
Russia	43
Spain	41
China	16

Source: PepsiCo Investor Presentation by Mike White, CEO PepsiCo International, 2006.

PepsiCo management believed international markets offered the company's greatest opportunity for growth since per capita consumption of snacks in the United States averaged 6.6 servings per month, while per capita consumption in other developed countries averaged 4.0 servings per month and per capita consumption in developing countries averaged 0.4 servings per month. PepsiCo executives expected that, by 2010, China and Brazil would be the two largest international markets for snacks. The United Kingdom was projected to be the third largest international market for snacks, while developing markets Mexico and Russia would be the fourth and fifth largest international markets, respectively.

Developing an understanding of consumer taste preferences was a key to expanding into international markets. Taste preferences for salty snacks were more similar from country to country than many other food items, which allowed PepsiCo to make only modest modifications to its snacks in most countries. For example, classic varieties of Lay's, Doritos, and Cheetos snacks were sold in Latin America. However, the company supplemented its global brands with varieties spiced to local preferences such as the seaweed-flavored Atesanas chips sold in Thailand and Lay's White Mushroom potato chips sold in Russia. In addition, consumer characteristics in the United States that had forced snack food makers to adopt better-for-you or good-for-you snacks applied in most other developed countries as well. In 2007, PepsiCo was eliminating trans fats from its snacks and expanding the nutritional credentials of its snacks sold in Europe, since demand for health and wellness products in Europe was growing by 10–13 percent per year. The annual revenue growth for core salty snacks in Europe was growing at a modest 4–6 percent per year. Among PepsiCo's fastest-growing snacks in the United Kingdom was Walker's baked potato chips, which had 70 percent less saturated fat and 25 percent less salt than regular Walker's chips. Walker's baked potato chips was named Britain's best new product of 2007 by *Marketing Week*mag azine.

INTERNATIONAL SALES OF QUAKER OATS PRODUCTS PepsiCo International also manufactured and distributed Quaker Oats oatmeal and cereal in international markets. In 2006, 75 percent of Quaker Oats' international sales of $500 million was accounted for by just six countries. The United Kingdom was Quaker's largest market outside the United States, where it held more than a 50 percent market share in oatmeal. The company had launched new oatmeal products in the United Kingdom, including Organic Oats, OatSo Simple microwaveable oatmeal and oatmeal bars, and Oat Granola and Oat Muesli cereals. PepsiCo also added new varieties of Quaker oatmeal products in Latin America to double the brand's sales in the region. Exhibit 9 presents a breakdown of PepsiCo's net revenues and long-lived assets by geographic region.

QuakerF oodsN orth America

Quaker Oats produced, marketed, and distributed hot and ready-to-eat cereals, pancake mixes and syrups, and rice and pasta side dishes in the United States and Canada. The division recorded sales of approximately $1.8 billion in 2007. Sales volume of Quaker Foods products increased by 2 percent during 2007, with Quaker Oatmeal, Life cereal, and Cap'n Crunch cereal volumes increasing at mid-single-digit rates. Sales of Aunt Jemima syrup and pancake mix declined slightly, while sales of Rice-A-Roni and PastaRoni kits declined at a double-digit rate during 2007. Quaker Oats was the star product of the division, with a 58 percent market share in North America in 2006. Rice-A-Roni held a 33 percent market share in the rice and pasta side dish segment of the consumer food industry. Quaker Foods was the third largest ready-to-eat cereal maker, with a 14 percent market share in 2005. In 2005, Kellogg's held a 30 percent share of the $6 billion ready-to-eat cereal market and General Mills held a 26 percent market share. Quaker grits and Aunt Jemima pancake mix and syrup competed in mature categories, and all enjoyed market leading positions. More than half of Quaker Foods' 2007 revenues were generated by better-for-you and good-for-you products.

Exhibit 9

PepsiCo Inc.'s U.S. and International Sales and Long-Lived Assets, 2004–2007 (in millions)

	2007	2006	2005	2004
Net Revenues				
United States	$21,978	$20,788	$19,937	$18,329
Mexico	3,498	3,228	3,095	2,724
United Kingdom	1,987	1,839	1,821	1,692
Canada	1,961	1,702	1,509	1,309
All other countries	10,050	7,580	6,200	5,207
Total	$39,474	$35,137	$32,562	$29,261
Long-Lived Assets				
United States	$12,498	$11,515	$10,723	$10,212
Mexico	1,067	996	902	878
United Kingdom	2,090	1,995	1,715	1,896
Canada	699	589	582	548
All other countries	6,441	4,725	3,948	3,339
Total	$22,795	$19,820	$17,870	$16,873

Source: PepsiCo Inc., 2006 10-K report.

ValueC hain Alignmentbet ween PepsiCo Brands and Products

PepsiCo's management team was dedicated to capturing strategic fit benefits within the business lineup throughout the value chain. The company's procurement activities were coordinated globally to achieve the greatest possible economies of scale, and best practices were routinely transferred between its 230 plants, 3,600 distribution systems, and 120,000 service routes around the world. PepsiCo also shared marketed research information to better enable each division to develop new products likely to be hits with consumers and coordinated its Power of One activities across product lines.

PepsiCo management had a proven ability to capture strategic fits between the operations of new acquisitions and its other businesses. The Quaker Oats integration produced a number of noteworthy successes, including $160 million in cost savings resulting from corporatewide procurement of product ingredients and packaging materials and an estimated $40 million in cost savings attributed to the joint distribution of Quaker snacks and Frito-Lay products. Also, the combination of Gatorade and Tropicana hot fill operations saved an estimated $120 million annually by 2005.

PepsiCo's Strategic Realignment in 2008

For the most part, PepsiCo's strategies seemed to be firing on all cylinders in 2007. PepsiCo's chief managers expected the company's lineup of snack, beverage, and grocery items to generate operating cash flows sufficient to reinvest in its core businesses, provide cash dividends to shareholders, fund an $8 billion share buyback plan, and pursue acquisitions that would provide attractive returns. Nevertheless, the low relative profit margins of PepsiCo's international businesses created the need for a new organizational structure that might better exploit strategic fits between the company's international operations.

Beginning in 2008, PepsiCo's former Frito-Lay North America, Quaker Foods North America, and all of its food and snack businesses in Latin America would be combined into a common PepsiCo Americas Foods division. The Latin American beverage businesses would be pulled from the PepsiCo International division and combined with PepsiCo Beverages North America to form the PepsiCo Americas Beverages division. PepsiCo International would include all of the company's snack and beverage businesses outside of North America and Latin America. The new three-division structure would include six reporting segments: Frito-Lay North America, Quaker Foods North America, Latin American Foods, PepsiCo Americas Beverages, United Kingdom & Europe, and Middle East, Africa & Asia. Some food and beverage industry analysts had speculated that corporate strategy changes might also be required to improve the profitability of PepsiCo's international operations and to help restore share price appreciation. Possible actions might include a reprioritization of internal uses of cash, new acquisitions, further efforts to capture strategic fits existing between the company's various businesses, or the divestiture of businesses with poor prospects of future growth and minimal strategic fit with PepsiCo's other businesses.

Endnotes

[1] As quoted in "Snack Attack," *Private Label Buyer,* August 2006, p. 26.

[2] "PepsiCo's New Formula," *BusinessWeek Online,* April 10, 2000.

Case 11

Adidas in 2009: Has Corporate Restructuring Increased Shareholder Value?

John E. Gamble
University of South Alabama

For more than a decade, adidas AG's corporate strategy had been focused on making acquisitions that would allow it to surpass Nike as the leader of the global sporting goods industry. The company's 1998 acquisition of French sporting goods manufacturer and marketer Salomon SA diversified it beyond footwear and apparel and into ski equipment, golf clubs, bicycle components, and winter sports apparel. The €1.5 billion acquisition allowed adidas to surpass Reebok to become the world's second largest sporting goods company with 1998 sales of nearly €5.1 billion. However, almost as soon as the deal was consummated, it looked doubtful that the acquisition would help adidas achieve its strategic intent of becoming the world's largest seller of sporting goods. Chief concerns with the acquisition were the declining attractiveness of the winter sports industry and integration problems between the adidas footwear and apparel business and Salomon's business units. Not until 2003, five years after the acquisition, had adidas' earnings per share returned to the level that shareholders enjoyed in 1997. In addition, the company's stock price failed to return to its 1998 trading range until 2004.

Adidas management divested all of Salomon's winter sports and bicycle components brands in 2005 to Amer Sports Corporation for €485 million. The divestiture of Salomon's winter sports and bicycle components business made TaylorMade Golf the lone business retained from the company's 1998 acquisition of Salomon SA. Adidas management followed the divestiture of Salomon business units with the €3.1 billion acquisition of Reebok International Ltd. in 2006. In addition to Reebok branded athletic footwear and apparel, Reebok International also designed, marketed, and sold Rockport footwear, Greg Norman apparel, and CCM hockey equipment.

The Reebok acquisition increased the company's revenues from €5.8 billion in 2005 to €10.1 (approximately $13.3 billion) in 2006 and brought it closer to Nike, which ended fiscal 2006 with total revenues of $14.9 billion. Adidas revenues had grown to €10.8 billion by year-end 2008, but Nike continued to hold a substantial lead over adidas in the United States athletic footwear market with a 34.6 percent market share compared to a combined 8.5 percent market share for adidas and Reebok branded footwear in 2008. Evidence seemed to be mounting to support the thesis of New Balance CEO Jim Davis, who, upon hearing of adidas management's latest round of corporate restructuring in 2005 and 2006, concluded, "You can try to take on Nike, but . . . Nike is Nike and will continue to be Nike.[1]

Through the first six months of 2009, adidas' corporate restructuring had failed to produce any lasting increases in shareholder value, with its shares trading in a range similar to its 2005 trading range. To make matters worse, an international recession that began in late 2007 had hit adidas and others in the sporting goods industry particularly hard. The company's revenues had begun to decline by late 2008, but fell by 7 percent during the first half of 2009 when compared to the first six months of 2008 as consumers in North America, Europe, and Asia curtailed discretionary purchases. Adidas' operating profit declined by 11 percent during first six months of 2009 when compared to the same period in 2008 as volume declined, materials prices increased, and more promotions were needed to generate sales.

A summary of adidas' financial performance for 1998 through 2008 is presented in Exhibit1 . The performance of the company's common shares between October 1999 and August 2009 is provided in Exhibit 2. Exhibit 3 presents balance sheets for adidas for 2007 and 2008.

CompanyH istory

The history of adidas can be traced to 1920, when German baker Adolph (nicknamed Adi) Dassler began trying his hand at designing and producing footwear for athletes competing in soccer, tennis, and track and field events. In 1924, Adolph Dassler's brother, Rudolph, joined him in the shoemaking venture to establish Gebrüder Dassler Schuhfabrik (translated in English as Dassler Brothers Shoe Factory). The Dasslers made their first major innovation in athletic shoe design in 1925 when they integrated studs and spikes into the soles of track and field shoes. The Dassler brothers continued to develop key innovations in athletic footwear such as the arch support. Many of the standard features of today's athletic footwear were developed by the Dassler brothers, with Adi Dassler alone accumulating 700 patents and property rights worldwide by the time of his death in 1978.

The Dasslers were also innovators in the field of marketing—giving away their shoes to German athletes competing in the 1928 Olympic Games in Amsterdam. By the 1936 Olympic Games in Berlin, most athletes would compete only in Gebrüder Dassler shoes, including Jesse Owens who won four gold medals in the Berlin games. By 1937, the company was making 30 different styles of shoes for athletes in 11 sports. All of the company's styles were distinguished from other brands by two stripes applied to each side of the shoe.

The Dasslers' sports shoe production ceased during World War II when Gebrüder Dassler Schuhfabrik was directed to produce boots for the armed forces of Nazi Germany. Adi Dassler was allowed to remain in Herzogenaurach to run the factory, but Rudolph (Rudi) Dassler was drafted into the army and spent a year in an Allied prisoner-of-war camp after being captured. Upon the conclusion of the war, Rudi Dassler was released by the Allies and returned to Herzogenaurach to rejoin his family. The Dasslers returned to production of athletic shoes in 1947, but the company was dissolved in 1948 after the two brothers entered into a bitter feud. Rudi Dassler moved to the other side of the small village to establish his own shoe company, Puma Schuhfabrik Rudolph Dassler. With the departure of Rudi Dassler, Adi renamed the company adidas—a combination of his nickname and the first three letters of his last name. Adi Dassler applied a third stripe to the sides of adidas shoes and registered the three stripe trademark in 1949.

The nature of the disagreement between the two brothers was never known for certain, but the two never spoke again after their split and the feud became the foundation of both organizations' cultures while the two brothers were alive. The two rival companies were highly competitive and both companies discouraged employees from fraternizing with cross-town rivals. An adidas spokesperson described the seriousness of the feud: "Puma employees wouldn't be caught dead with adidas employees. . . . It wouldn't be allowed that an adidas employee would fall in love with a Puma employee."[2]

Adi Dassler kept up his string of innovations with molded rubber cleats in 1949, and in 1952 he developed track shoes with screw-in spikes.

Exhibit 1

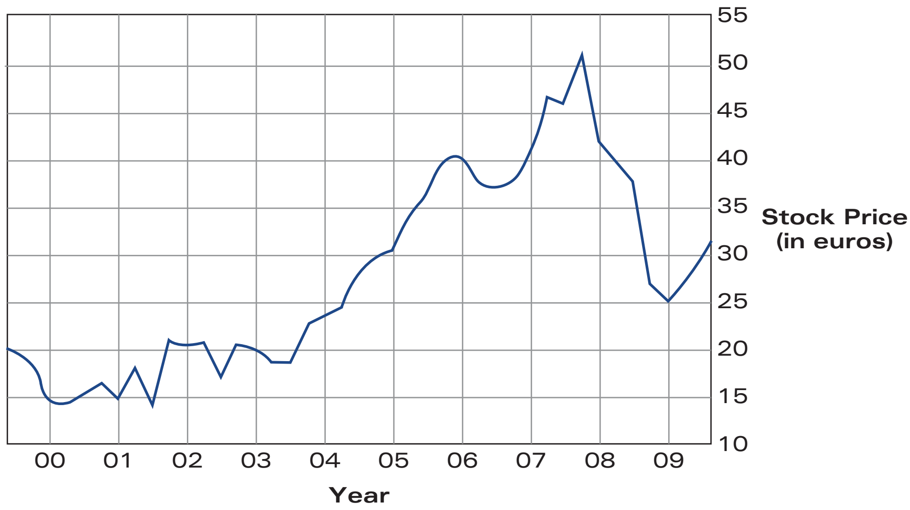
Financial Summary for adidas AG, 1998–2008 (in millions except per share data)

	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998
Net sales	€ 10,799	€ 10,299	€ 10,084	€ 6,636	€ 5,860	€ 6,267	€ 6,523	€ 6,112	€ 5,835	€ 5,354	€ 5,065
Cost of sales	5,543	5,417	5,589	3,439	3,047	3,453	3,704	3,511	3,307	3,002	2,941
Gross profit	5,256	4,882	4,495	3,197	2,813	2,814	2,819	2,601	2,528	2,352	2,124
Royalty and commission income	89	102	90	47	42	42	46	42	43	35	45
Operating expenses	4,275	4,035	3,704	2,537	2,236	2,324	2,343	2,126	2,091	1,870	1,698
Operating profit	1,070	949	881	707	584	490	477	475	437	482	416
Financial expenses, net	166	135	158	52	59	49	87	102	94	84	115
Income before taxes	904	815	723	655	526	438	390	376	347	398	319
Income taxes	260	260	227	221	193	167	148	147	140	153	105
Minority interests	2	4	13	8	7	11	14	21	25	18	9
Net income	€ 642	€ 551	€ 483	€ 426	€ 326	€ 260	€ 228	€ 208	€ 182	€ 227	€ 205
Basic earnings per share	€ 3.25	€ 2.71	€ 2.37	€ 2.05	€ 1.72	€ 1.43	€ 1.26	€ 1.15	€ 1.00	€ 1.26	€ 1.13
Diluted earnings per share	€ 3.07	€ 2.57	€ 2.25	€ 1.93	€ 1.64	€ 1.43	€ 1.26	€ 1.15	€ 1.00	€ 1.26	€ 1.16
Dividends per share	€ 0.50	€ 0.50	€ 0.42	€ 0.33	€ 0.33	€ 0.25	€ 0.25	€ 0.23	€ 0.23	€ 0.23	€ 0.21
Number of shares outstanding at year-end	193,516	203,629	203,537	203,047	183,436	181,816	181,692	181,396	181,396	181,396	181,396

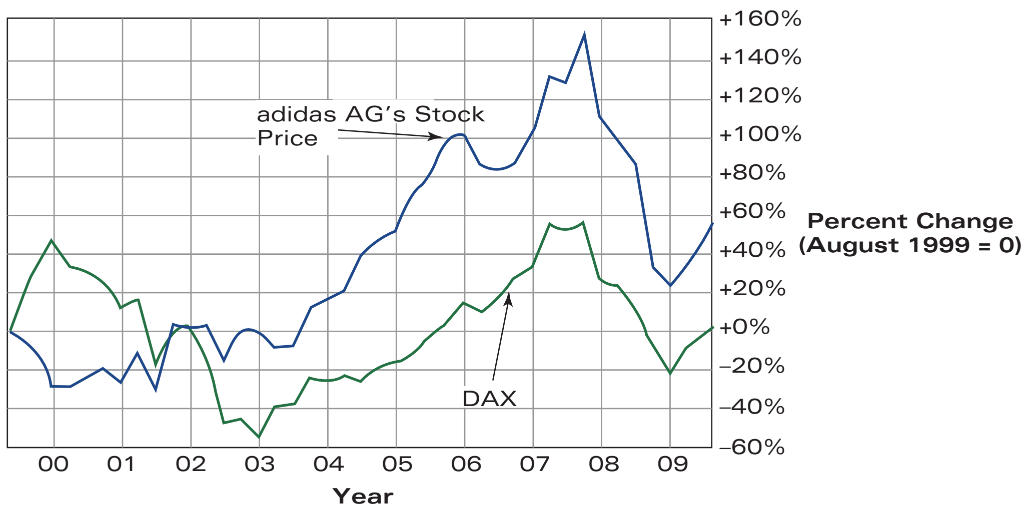
Source: adidas AG Annual Reports, various years.

EXHIBIT 2 **Performance of adidas AG's Stock Price, October 1999–August 2009**

(a) Trend in adidas AG's Common Stock Price



(b) Performance of adidas AG's Stock Price versus the DAX Index



He expanded the concept to soccer shoes in 1954 with screw-in studs, which has been partially credited for Germany's World Cup Championship that year. By 1960, adidas was the clear favorite among athletic footwear brands with 75 percent of all track and field athletes competing in the Olympic Games in Rome wearing adidas shoes. The company began producing soccer balls in 1963 and athletic apparel in 1967. The company's dominance in the athletic footwear industry continued through the early 1970s with 1,164 of the 1,490 athletes competing in the 1972 Olympic Games in Munich wearing adidas shoes. As jogging developed into a popular recreational activity in the early 1970s, adidas became the leading brand of consumer jogging shoe in the United States. Also, T-shirts and other apparel bearing adidas' three-lobed trefoil logo were popular wardrobe items for U.S. teenagers during the 1970s.

Exhibit 3

Adidas AG Balance Sheets, 2007–2008 (in millions)

	December 31,	
	2008	**2007**
Assets		
Cash and cash equivalents	€ 244	€ 295
Short-term financial assets	141	86
Accounts receivable	1,624	1,459
Inventories	1,995	1,629
Other current assets	930	669
Total current assets	4,934	4,138
Property, plant and equipment, net	886	702
Goodwill, net	1,499	1,436
Trademarks	1,390	1,291
Other intangible assets, net	204	194
Long-term financial assets	96	103
Deferred tax assets	344	315
Other noncurrent assets	180	147
Total noncurrent assets	4,599	4,188
Total assets	€ 9,533	€ 8,325
Liabilities, minority interests and shareholders' equity		
Short-term borrowings	€ 797	€ 186
Accounts payable	1,218	849
Income taxes	321	285
Accrued liabilities and provisions	1,008	1,025
Other current liabilities	301	270
Total current liabilities	3,645	2,615
Long-term borrowings	1,776	1,960
Pensions and similar obligations	132	124
Deferred tax liabilities	463	450
Other noncurrent liabilities	117	142
Total noncurrent liabilities	2,488	2,676
Minority interests	14	11
Shareholders' equity	3,386	3,023
Total liabilities, minority interests and shareholders' equity	€ 9,533	€ 8,325

Source: Adidas AG 2008 Annual Report.

At the time of Adi Dassler's death in 1978, adidas remained the worldwide leader in athletic footwear, but the company was rapidly losing market share in the United States to industry newcomer Nike. The first Nike shoes appeared in the 1972 U.S. Olympic Trials in Eugene, Oregon, and had become the best-selling training shoe in the United States by 1974. Both Adi Dassler and his son Horst, who took over as adidas' chief manager after Adi Dassler's death, severely underestimated the threat of Nike. With adidas perhaps more concerned with cross-town adversary Puma, Nike pulled ahead of its European rivals in the U.S. athletic footwear market by launching new styles in a variety of colors and by signing recognizable sports figures to endorsement contracts. Even though Nike was becoming the market leader in U.S. athletic footwear market, adidas was able to retain its number-one ranking among competitive athletes, with 259 gold medal winners in the 1984 Olympic Summer Games in Los Angeles wearing adidas products. Only 65 Olympic athletes wore Nike shoes during the 1984 Summer Games, but the company signed up-and-coming NBA star Michael Jordan to a

$2.5 million endorsement contract after adidas passed on the opportunity earlier in the year. At the time of Horst Dassler's unexpected death in 1987, Nike was the undisputed leader in the U.S. athletic footwear market with more than $1 billion in annual sales.

Adidas' performance spiraled downward after the death of Horst Dassler, with no clear direction from the top and quality and innovation rapidly deteriorating. By 1990, adidas had fallen to a number-eight ranking in the U.S. athletic footwear market and held only a 2 percent share of the market. A number of management and ownership changes occurred between Horst Dassler's death in 1987 and 1993, when a controlling interest in the company was acquired by a group of investors led by French advertising executive Robert Louis-Dreyfus. Louis-Dreyfus launched a dramatic turnaround of the company—cutting costs, improving styling, launching new models, and signing endorsement contracts with popular athletes such as Kobe Bryant, Anna Kournikova, and David Beckham. At year-end 1994, adidas had increased its annual sales in the United States by 75 percent from the prior year and improved its market share enough to become the third largest seller of athletic footwear in the United States, trailing only Nike and Reebok.

The1 998 Salomon SA Acquisition

Even though the company's turnaround had produced outstanding results with sales and earnings growing at annual rates of 38.3 percent and 37.5 percent, respectively, between 1995 and 1997, the company was a distant number three in the worldwide athletic footwear and apparel industry. Nike's 1997 revenues of $9.2 billion were nearly three times greater than that of adidas, and Nike continued to grow at a fast pace as it expanded into more international markets. In late 1997, Louis-Dreyfus and the family owners of Salomon SA, a French sports equipment manufacturer, agreed to a €1.5 billion merger that would diversify adidas beyond footwear and apparel into ski equipment, golf clubs, bicycle components, and winter sports apparel. Salomon's business lineup contained a large number of strong businesses—its Salomon ski division was the leading producer of ski equipment; TaylorMade Golf was the second largest seller of golf equipment; and Mavic was the leading producer of high-performance bicycle wheels and rims. Other Salomon businesses included Bonfire snowboard apparel and Cliché skateboard equipment.

Adidas' €1.5 billion acquisition of Salomon SA allowed it to surpass Reebok to become the world's second largest sporting goods company with 1998 sales of nearly €5.1 billion. The price of adidas' shares fell upon the announcement of the acquisition over concerns about the high price adidas agreed to pay for Salomon and how the company might finance the acquisition. There was also some concern among investors that adidas did not have expertise in manufacturing sports equipment since its apparel and footwear were produced by contract manufacturers. A Merrill Lynch analyst suggested the Salomon acquisition might prove troublesome for adidas since other athletic shoe companies had "dabbled in the hard goods segment, but they have been unsuccessful to date in making inroads."[3]

Louis-Dreyfus expected the Salomon acquisition to boost the company's pretax profits by 20–25 percent annually through 2000. However, Louis-Dreyfus' projections never materialized with adidas taking control of Salomon just as the winter sports equipment and golf equipment industries were becoming less attractive. The poor performance of Salomon and TaylorMade in 1998 led to a net loss of $164 million for adidas-Salomon during the first nine months of its fiscal year. To make matters worse, the integration of Salomon's bicycle components, skateboard, winter sports, and golf equipment businesses did not go as smoothly as Louis-Dreyfus and adidas' shareholders had expected.

By summer 1999, adidas-Salomon's share price had declined by more than a third from its early 1998 high, and most large investors believed adidas had "bitten off more than it could chew" with the acquisition.[4] Robert Louis-Dreyfus announced in early 2000 that he would step down from adidas-Salomon and rejoin his family's business in France in early 2001. Herbert Hainer, the company's head of marketing in Europe and Asia, was tapped as his replacement to run the diversified sporting goods company. Under Hainer's leadership, the company cut costs, introduced new apparel and footwear products, increased the company's advertising, signed additional athletes to endorsement contracts, and opened extended retail distribution to company-owned stores.

Adidas'B roadC orporate Restructuring Plan

Adidas' 1998 acquisition of diversified sporting goods producer Salomon was expected to allow the athletic footwear company to vault over Nike to become the leader of the global sporting goods industry. But almost as soon as the deal was consummated, it looked doubtful that the €1.5 billion acquisition of Salomon would help adidas achieve its strategic intent. Chief concerns with the acquisition were the declining attractiveness of the winter sports industry and integration problems between the adidas footwear and apparel business and Salomon's business units. Not until 2003, five years after the acquisition, had adidas' earnings per share returned to the level that shareholders enjoyed in 1997. In addition, the company's stock price failed to return to its 1998 trading range until 2004. The Salomon winter sports business had contributed very little operating profit to the company's overall financial performance since its acquisition, and the TaylorMade-adidas Golf division had struggled at various times to deliver good earnings. However, TaylorMade seemed to have turned the corner in 2005 with sales and operating earnings finally improving after a three-year decline.

The2 005D ivestitureo f Salomon Business Units

The company divested all of its winter sports brands and Mavic bicycle components business in October 2005 to Amer Sports Corporation for €485 million. Amer Sports was the maker of Atomic skis and Wilson sporting goods. The divestiture of Salomon's winter sports and bicycle components business would make TaylorMade Golf the lone business retained from the company's 1998 acquisition of Salomon SA. Upon the completion of the Salomon divestiture, adidas-Salomon's shareholders approved a resolution to change the company's name to adidas AG.

The2 006 Acquisitiono f Reebok International Ltd.

With the Salomon divestiture to Amer Sports all but consummated, adidas management announced in August 2005 that it would acquire Reebok International Ltd. for €3.1 billion. The acquisition of Reebok would be the final component of a restructuring initiative that would focus the company's business lineup primarily on athletic footwear and apparel and golf equipment by 2006. In addition to Reebok-branded athletic footwear and apparel, Reebok International also designed, marketed, and sold Rockport footwear, Greg Norman apparel, and CCM hockey equipment. In 2004, Rockport and Reebok's hockey brands contributed $377.6 million and $146.0 million, respectively, to the company's total sales of nearly $3.8 billion. The company's sales of Greg Norman golf apparel approximated $50 million in 2004. Exhibit 4 provides Reebok International's sales by product line and by geographic region for 2002 through 2004.

The Reebok acquisition, which was finalized in 2006, increased the company's revenues from €5.8 billion in 2005 to €10.1 in 2006 and allowed sales in North America to more than double between 2005 and 2006. In addition, adidas expected to capture annual cost-sharing benefits of approximately €125 million within three years of the closing date. The company's post-merger branding strategy would position adidas as a technologically superior shoe designed for serious athletes, while Reebok would be positioned as a leisure shoe that would sell at middle price points. Adidas divested the Greg Norman golf apparel line shortly after the completion of the Reebok acquisition.

Exhibit 4

Reebok International Net Sales, 2002–2004

Reebok International's net sales by product type:

	2004	2003	2002
Net sales:			
Footwear	$ 2,430,311	$ 2,226,712	$ 2,060,725
Apparel	1,354,973	1,258,604	1,067,147
	$ 3,785,284	$ 3,485,316	$ 3,127,872

Reebok International's net sales by geographic region:

	2004	2003	2002
Net sales:			
United States	$ 2,069,055	$ 2,021,396	$ 1,807,657
United Kingdom	474,704	444,693	416,775
Europe	810,418	692,400	607,381
Other countries	431,107	326,827	296,059
	$ 3,785,284	$ 3,485,316	$ 3,127,872

Source: Reebok International, Ltd. 2004 10-K.

Performance Expectations for Adidas' Restructured Business Lineup

Even though the restructured lineup of businesses offered adidas an improved chance of catching Nike in its race to be the world's largest sporting goods company, some observers were not convinced the move would prove to be any more successful than the company's 1998 acquisition of Salomon. The president of a sports marketing firm doubted adidas' "German mentality of control, engineering, and production" would prove to be compatible with Reebok's "U.S. marketing-driven culture" and added "in reality, I don't think [the merged company] is going to dent the market, because Nike is already too far ahead."[5] A Goldman Sachs analyst added "We fail to see how this combo will erode Nike's franchise as the global brand leader."[6]

Adidas' Corporate Strategy in 2009

In 2009, adidas' businesses were organized under three units based around the company's core brands—adidas, Reebok, and TaylorMade-adidas Golf. The company's corporate strategy was focused on extending its leadership in product innovation, creating a differentiated image for the products offered by each of its three business segments, expanding controlled retail space through its network of company-owned stores, and achieving efficiencies in its global supply chain processes and activities. The relative performance of adidas' business units during 1998 through 2008 is presented in Exhibit 5.

Adidas' corporate focus on product design and innovation contributed to the differentiation strategies employed in each of its businesses. Each business unit was expected to develop at least one major product innovation per year in each product category. In 2009, TaylorMade Golf introduced its r9 driver that incorporated nine movable weights and an adjustable shaft. The movable weights and adjustable shaft allowed golfers to create 24 different configurations to produce over 1,000 different ball flight trajectories. In 2008, the adidas athletic footwear and apparel division introduced its innovative SelectRide running shoe and F50 Tunit soccer shoe families and a Cirque du Soleil gym and yoga apparel collection. Reebok's most notable product launch in 2008 was its EasyTone women's walking shoe line that utilized spongy

Exhibit 5

Adidas AG Financial Data by Operating Segment, 1998–2008 (in millions)

BUSINESS SEGMENT	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998
Adidas											
Sales	€ 7,821	€ 7,133	€ 6,626	€ 5,861	€ 5,174	€ 4,950	€ 5,105	€ 4,825	€ 4,672	€ 4,427	€ 4,316
Gross profit	3,802	3,370	3,059	2,654	2,284	2,008	2,004	1,845	1,907	1,827	1,818
Operating profit	1,098	920	788	693	564	365	343	352	391	431	412
Operating assets	3,872	3,329	3,211	2,526	2,089	2,172	2,294	1,954	2,286	1,987	1,730
Capital expenditures	189	150	135	138	85	63	84	113	93	105	102
Amortization and depreciation	117	104	91	69	56	56	63	57	52	45	48
Reebok[1]											
Sales	€ 2,148	€ 2,333	€ 2,473	—	—	—	—	—	—	—	—
Gross profit	795	902	863	—	—	—	—	—	—	—	—
Operating profit	(7)	109	86	—	—	—	—	—	—	—	—
Operating assets	3,033	2,913	3,217	—	—	—	—	—	—	—	—
Capital expenditures	53	57	72	—	—	—	—	—	—	—	—
Amortization and depreciation	60	60	53	—	—	—	—	—	—	—	—
TaylorMade-adidas Golf											
Sales	€ 812	€ 804	€ 856	€ 709	€ 633	€ 637	€ 707	€ 545	€ 441	€ 327	€ 263
Gross profit	359	360	376	312	298	290	345	281	221	160	118
Operating profit	78	65	73	50	48	67	74	63	44	30	20
Operating assets	748	629	656	692	619	391	433	316	219	156	99
Capital expenditures	15	12	13	17	9	12	49	16	12	10	16
Amortization and depreciation	11	12	13	13	11	9	7	6	4	4	2
Salomon											
Net sales	—	—	—	—	€ 653	€ 658	€ 684	€ 714	€ 703	€ 587	€ 487
Gross profit	—	—	—	—	259	264	279	313	296	233	188
Operating profit	—	—	—	—	9	35	39	63	61	32	6
Operating assets	—	—	—	—	505	521	581	679	566	533	598
Capital expenditures	—	—	—	—	19	18	18	38	24	17	20
Amortization and depreciation	—	—	—	—	7	7	7	7	7	5	7
Corporate/Consolidation											
Sales	€ 18	€ 49	€ 129	€ 66	€ 53	€ 22	€ 27	€ 28	€ 19	€ 10	—
Gross profit	300	250	195	232	232	252	191	162	104	—	—
Operating profit	(99)	(145)	(66)	(36)	(27)	23	21	(3)	(59)	(14)	(22)
Operating assets	1,880	1,454	1,295	2,532	1,072	1,104	953	1,234	947	903	782
Capital expenditures	123	70	57	45	27	29	22	20	16	—	—
Amortization and depreciation	33	25	25	30	28	17	26	25	23	6	6

[1]2006 financial data is for an 11-month period because of the closing date of the Reebok International acquisition by adidas AG.

Source: adidas AG 2005, 2007, and 2008 Annual Reports.

balance pods in the sole to encourage leg toning while walking or exercising. The company also improved the comfort of its Rockport footwear collection in 2008 by incorporating its Torsion system developed for adidas running shoes.

Adidas also relied heavily on ongoing brand-building activities to further differentiate adidas, Reebok, and TaylorMade from competing brands of sporting goods. Partnerships with major sporting events around the world and with notable athletes competing in track and field, soccer, basketball, tennis, and golf were critical to creating a distinctive image with consumers. The company also attempted to provide its retailers with superior customer service, including on-time deliveries, since retailer activities were such important elements of the sporting goods industry value chain.

Adidas management believed that controlled retail space would provide customers with a thorough understanding of product features and offer consumers a rewarding point-of-sale experience. In 2009, the company's controlled space included mono-branded retail stores, shop-in-shop locations, factory outlet stores, team apparel stores located in stadiums and arenas, and e-commerce sites. Adidas had opened company-owned retail stores in the United States and Europe and such emerging markets as Russia and China. Adidas management expected its company-owned retail stores to generate at least 35 percent of its revenues by 2012. Table 6 presents the number of adidas and Reebok locations in 2007 and 2008.

Exhibit 6

Number of Company-Owned adidas and Reebok Retail Stores, 2007, 2008

COMPANY-OWNED ADIDAS RETAIL STORES	2008	2007
Sport Performance stores	652	459
Originals stores	140	83
Sport Style stores	4	—
Factory outlets	381	317
Concession sales locations	150	142
Consumer e-commerce sites	5	2
Total U.S. Retail Locations	1,332	1,003

COMPANY-OWNED REEBOK RETAIL STORES	2008	2007
Factory outlets	327	287
Concept stores	253	164
Concession sales locations	67	73
	647	524

Efficient supply chain management was critical to adidas' profitability because of the importance of getting new styles to market quickly and because of the importance of low-cost manufacturing. Adidas kept its production costs low by outsourcing more than 97 percent of its footwear and 83 percent of its apparel production requirements to contract manufacturers located throughout Asia. In 2005, the company launched a "World Class Supply Chain" initiative to improve coordination with its contract manufacturers, get new products to market more quickly, and lower costs. The initiative allowed adidas to reduce its number of contract manufacturers from 547 in 2005 to 300 in 2008, thereby reducing complexities in its procurement planning. The reduced number of suppliers also allowed the company to better respond to rapid changes in the marketplace that called for certain styles to be discontinued or production of others to be increased. The fewer number of contract manufacturers also allowed Adidas to speed its product design-to-market cycle times. Adidas management also reengineered replenishment activities to improve product availability to retailers without substantially boosting its inventories of footwear, apparel, and sporting goods hardware.

AdidasF ootwearan d Apparel

Adidas' core footwear and apparel business competed in the $125 billion sports apparel and footwear industry. The annual growth rate for the global athletic footwear and apparel industry had slowed from 6.8 percent in 2005 to 3.3 percent in 2007. At about $42.5 billion, North America was the largest market for athletic apparel and footwear, but its 3 percent annual growth rate was greater than only Europe's 2 percent annual growth rate among all developed and emerging markets for athletic apparel and footwear. Markets in Eastern

Europe, South and Central Asia, and China grew at rates of 20 percent, 13 percent, and 15 percent, respectively, between 2006 and 2007.

In 2008, however, worldwide athletic footwear and apparel industry sales failed to grow, with the global economy for all goods and services expanding by only 2 percent compared to a 4 percent increase in global gross domestic product (GDP) in 2007. Adidas' largest markets were most affected by the global economic slowdown—GDP declined by 1.3 percent in the United States and grew by just 0.9 percent in Europe during 2008. Latin America and Asia had been less affected by the recession with the GDPs of both Asia and Latin America increasing by 4.2 percent in 2008. Industry revenues grew by 4 percent in Asia and 7 percent in the Middle East/Africa in 2008 and declined in North America and Europe by 1 percent during 2008. The international economic slowdown had intensified in 2009 and had led to steeper drops in industry revenues. Most industry analysts did not expect industry sales to grow through 2010.

Adidas footwear and apparel was organized under two categories which were based upon the clothing needs of the consumer. The adidas Sport Performance group developed sports shoes and attire that was suitable for use by athletes in four key sports categories—running, soccer, basketball, and general training. The Sport Style product line was marketed to those who enjoyed the comfort of athletic apparel.

Soccer was adidas' strongest product category where it held market shares greater than 50 percent in Europe and North America. Adidas was runner-up to Nike in most other athletic categories where it competed. It maintained its advantage over other sporting attire and footwear producers primarily through innovations like its AdiSTAR cushion system for running shoes and its TECHFIT athletic apparel designed to increase blood flow during athletic activity and through endorsements by individual athletes or league sponsorships. Kevin Garnett, Dwight Howard, and Tracy McGrady were among the latest NBA athletes to endorse adidas footwear and apparel. In soccer, players such as David Beckham, Lionel Messi, and entire clubs endorsed adidas soccer shoes and clothing. Adidas was the official sponsor for the German national women's team and UEFA European soccer league teams in Munich, Amsterdam, Milan, and Madrid. Also, the adidas Roteiro was the Official Match Ball for all UEFA games. Adidas was also the official sportswear partner of the 2008 Beijing Olympics and the London Olympics set for 2012. The Sport Performance group accounted for 80 percent of adidas-branded apparel and footwear sales in 2008. Sport Performance sales increased by 15 percent between 2007 and 2008.

The company's Sport Style streetwear and lifestyle fashion group represented a relatively small fraction of adidas' overall apparel and footwear sales, but offered high profit margins because of the small research and development budget needed to design such items. Another attractive aspect of adidas' lifestyle apparel group was that the market for sports lifestyle apparel and footwear was growing at a faster rate than the market for actual sports products. The Sport Style group included two segments—adidas Originals and Y-3. Adidas Originals targeted consumers in three distinct categories—hip hop, surfers and skateboarders, and young metropolitan consumers. Adidas Originals products designed for the hip hop and surfer/skater lifestyle included items such as warm-up suits, T-shirts, and updated versions of classic adidas court shoes. The company's products targeted toward young metropolitan consumers included a jeans line developed in collaboration with Diesel and its Grün footwear collection made from recycled materials. Adidas Y-3 ready-to-wear fashion collection was developed in collaboration with designer Yohji Yamamoto. Y-3 line included apparel items such as women's tights, skirts, blouses, and leather jackets. Y-3 apparel for men included jeans, coats, leather jackets, polo shirts, and stretch pants. The Sport Style group accounted for 20 percent of adidas-branded apparel and footwear sales in 2008. Sport Style sales improved by 10 percent between 2007 and 2008.

In 2008, Europe accounted for 50 percent of adidas-branded sales of footwear and apparel, North America accounted for 15 percent of adidas' total sales of athletic gear, Asia accounted for 27 percent of adidas-branded apparel and footwear sales, and Latin America accounted for 8 percent of the division's sales. Adidas had long held the title of market share leader in Europe's developed country markets for athletic footwear and apparel, but the company was intent to also hold leading positions in emerging markets in Eastern Europe and Asia. Sales had grown by as much as 50 percent annually in Russia and other former Soviet states such the Ukraine, Armenia, and Belarus to give it a 2-to-1 margin over runner-up Nike. Adidas management expected Russia to become its largest and most profitable market in Europe by 2010.

Asia was projected to become adidas' largest market overall within the near term because of the strong demand for athletic footwear and apparel in Asia and the vast numbers of consumers living in Asian country markets. Asia made up more than two-thirds of the world's population in 2008, and was projected to grow from 3.2 billion people in 2008 to 3.6 billion people by 2028. Adidas' emphasis on emerging markets had made it the largest seller of athletic gear in Asia in 2008 and the company expected to displace Nike as market leader in Latin America by 2010. The share of the North American athletic footwear market held by adidas-branded athletic footwear had declined from 10.62 percent in 2006 to 5.86 percent in 2008. Exhibit 7 presents market shares for the largest sellers of athletic footwear in the United States for 2006 through 2008. Exhibit 8 presents a summary of adidas AG's geographic financial performance for 1998 through 2008.

Exhibit 7

U.S. Retail Market Shares for the Leading Sellers of Athletic Footwear, 2006–2008

BRAND	2006	2007	2008
Nike*	29.73%	31.52%	34.61%
New Balance	9.26	8.03	6.26
Adidas	10.62	6.93	5.86
Reebok	4.68	4.43	2.66

*Does not include the Nike-owned Jordan or Converse brands.
Source: SportsOneSource.

Reebok

The Reebok brand was acquired by adidas AG in 2006 to boost the company's sales in North America. Approximately $2 billion of Reebok International's 2004 sales of $3.7 billion were generated in North America from the sale of Reebok athletic footwear and apparel; Reebok and CCM hockey skates, uniforms, and gear; Rockport men's shoes; and Greg Norman golf apparel. Adidas divested the Greg Norman apparel line soon after the completion of the 2006 acquisition of Reebok International.

At the time of its acquisition by adidas, the Reebok brand suffered from a poor reputation for quality, innovation, and styling. The company had struggled to develop a strong image with it changing marketing campaigns on a regular basis. Since Nike's launch of its "Just Do It" advertising campaign in 1988, Reebok had launched campaigns keyed to the taglines, "Time to Play," "Life is Short—Play Hard," "Pump Up," "Air Out," "Wear the Vector—Outperform," "Defy Convention," "Are You Feeling It?" "Planet Reebok," "Reebok Lets UBU," "Run Easy," and "I Am What I Am." Even though its most recent campaigns acknowledged its failure to appeal to athletically minded consumers, the brand did, however, have a loyal following among women participating in general fitness training, walking, and aerobics. In 2009, adidas management had chosen to use the Reebok brand of athletic footwear to focus on beginning and recreational runners and women athletes participating in running, aerobics, walking, and training. Reebok athletic shoes were also frequently purchased by women looking for comfortable casual shoes. The company developed a variety of new styles such as its EasyTone walking shoes that were intended to appeal to women and developed a partnership with the Avon Walk Around the World for Breast Cancer charitable organization to increase awareness of the Reebok brand among women.

Exhibit 8

Adidas AG Financial Data by Geographic Region, 1998–2008 (in millions)

REGIONS	2008	2007	2006	2005	2004	2003	2002	2001	2000	1999	1998
Europe											
Net sales	€ 4,665	€ 4,369	€ 4,162	€ 3,166	€ 3,068	€ 3,365	€ 3,200	€ 3,066	€ 2,860	€ 2,723	€ 2,774
Operating assets	2,319	1,819	1,808	1,376	1,461	1,428	1,396	1,419	1,107	1,167	1,114
Capital expenditures	102	105	84	57	46	44	56	74	55	40	35
North America											
Net sales	€ 2,520	€ 2,929	€ 3,234	€ 1,561	€ 1,332	€ 1,562	€ 1,960	€ 1,818	€ 1,907	€ 1,826	€ 1,784
Operating assets	1,659	1,489	1,564	325	768	778	969	945	862	848	666
Capital expenditures	45	34	49	51	27	22	82	68	54	26	29
Asia											
Net sales	€ 2,662	€ 2,254	€ 2,020	€ 1,523	€ 1,192	€ 1,116	€ 1,166	€ 1,010	€ 875	€ 663	€ 383
Operating assets	962	772	719	617	480	447	505	743	455	390	201
Capital expenditures	61	49	74	37	23	12	16	15	17	18	9
Latin America											
Net sales	€ 893	€ 657	€ 499	€ 319	€ 224	€ 179	€ 163	€ 178	€ 171	€ 126	€ 112
Operating assets	547	285	217	176	56	93	79	98	109	75	66
Capital expenditures	29	10	7	5	1	1	1	2	3	3	2
Headquarters/consolidation											
Net sales	€ 59	€ 89	€ 169	€ 66	€ 47	€ 45	€ 34	€ 40	€ 23	€ 34	€ 12
Operating assets	4,046	3,960	4,071	3,256	1,601	1,442	1,312	978	1,485	1,108	1,162
Capital expenditures	143	91	63	50	43	43	15	28	16	45	63

Source: Adidas AG 2005, 2007, and 2008 Annual Reports.

Adidas management had also undertaken efforts to improve Reebok's image in men's sports with endorsements from such professional athletes as Peyton and Eli Manning, Allen Iverson, Yao Ming, David Ortiz, and Vince Young. Reebok was also the official outfitter of the National Football League and was an apparel partner with Major League Baseball. Its relationship with the National Hockey League, the American Hockey League, and the Canadian Hockey League helped solidify Reebok-CCM as the number-one seller of hockey skates and gear. Reebok and CCM both offered complete head-to-toe product lines for hockey, but in 2008 the company had begun to position CCM as a premium skate brand and Reebok as general hockey equipment and apparel brand. Adidas' strategic priority for the Rockport line of casual men's shoes was to increase the brand's sales outside of North America. Adidas management expected that more than 50 percent of Rockport's sales would be generated in Europe, Asia, and Latin America by 2010.

Adidas management had also expanded Reebok's distribution beyond its historical focus on specialty athletic footwear stores and discount family footwear retailers to both improve its image and make Reebok shoes available to a wider range of consumers. Beginning in 2008, the company increased Reebok's distribution network to include a greater number of large sporting goods stores and department stores. Distribution was also improved by the addition of 95 additional concept stores and 52 additional factory outlet stores during 2008. Adidas also moved to control distribution of Reebok in emerging markets by purchasing distribution rights in Russia, Brazil, and China, which had been sold to third parties by Reebok International management. Adidas also began purchasing distribution rights for Rockport in emerging markets, which too had been sold to third parties by Reebok International management.

Reebok's net sales declined by 2 percent between 2007 and 2008, with sales of Reebok-branded shoes and apparel remaining unchanged between 2007 and 2008, Reebok-CCM hockey revenues declining by 6 percent during the year and Rockport sales declining by 10 percent between 2007 and 2008. Between 2006 and 2007, the sales of Reebok branded athletic footwear and apparel declined by 7 percent, sales of hockey equipment increased by 3 percent, and Rockport sales improved by 1 percent. Net sales during the 2007 fiscal year were also negatively affected by the divestiture of its Greg Norman apparel line, which had 2006 net sales of approximately $50 million. Operating profit margins for the Reebok division decreased from a positive 4.7 percent in 2007 to a negative 0.3 percent in 2008 (see Exhibit5).

TaylorMade-adidas Golf

TaylorMade Golf was the third largest producer of golf equipment in the $2.8 billion industry. The industry had struggled to find growth during the late 2000s as the number of golfers in the U.S. declined from more than 27 million in 1998 to 25.6 million in 2008. Also, rounds played had not grown appreciably between 2004 and 2007 and had declined by 1.8 percent during 2008 as consumers reacted to economic uncertainty by shifting discretionary income from spending to savings. Sales of golf equipment declined by 5.7 percent during 2008 and it appeared that 2009 industry sales would decline by an additional 15 to 20 percent.

TaylorMade-adidas Golf management expected to increase sales primarily through market share gains since they had concluded that it would be unwise to count on growth of the game. TaylorMade believed it could increase market share through endorsement contracts with touring professionals on the PGA Tour and other professional tours and through new product innovations like the movable weight and adjustable shaft systems used in its r9 driver. TaylorMade management also wished to achieve revenue growth by increasing sales in Asia. The company had successfully increased its sales in Asia from 13 percent of sales in 1999 to 37 percent of sales in 2008, and the United States accounted for less than 50 percent of sales in 2008 versus 69 percent of sales in 1999.

In 2009, TaylorMade was the largest seller of drivers, fairway woods, and hybrid clubs. TaylorMade maintained its lead in the driver category of the golf equipment industry with updated models that were launched at 12–18 month intervals. In 2009, the company's flagship r9 driver was among the most innovative in the industry and sold at a price point of $500. TaylorMade offered drivers at four different price points, with two r9 submodels selling for $400 and $300, two r7 models selling for $300 and $200, and three Burner models selling at price points of $400, $300, and $200.

Even though TaylorMade achieved the number-one ranking in metalwoods, its market share in irons was about one-half that of industry leader Callaway Golf Company, and its market share in wedges and putters was negligible. TaylorMade also produced and marketed a line of golf balls, but had not achieved any significant market success in the product category.

The sales of TaylorMade's adidas-branded golf apparel and golf shoes had grown at compounded annual rates of 23 percent and 13 percent, respectively, between 2004 and 2008 through the continued introduction of new styles and exposure on the professional tours by such well-known golfers as Sergio Garcia, Natalie Gulbis, Paula Creamer, and Retief Goosen. In all, TaylorMade-adidas Golf had signed endorsement contracts with 70 golfers on the men's and women's professional tours. The heavy reliance on endorsements by touring professionals made adidas the most widely worn apparel brand on the professional tours. Some of its touring staff was also compensated to use TaylorMade's TP Red or TP Black golf balls during tournaments. TaylorMade also had limited contracts with an additional 40 golfers to use TaylorMade drivers during professional tournaments. Exhibit 8 presents the TaylorMade-adidas Golf division's sales by product category for 2004–2008.

Exhibit 8

TaylorMade-adidas Golf Sales Contribution by Product Line, 2004–2008 (in millions)

	2008	2007	2006	2005	2004
Metalwoods	€ 309	€ 338	€ 325	€ 319	€ 304
Apparel	162	145	197	99	70
Footwear	73	72	60	50	44
Other hardware*	268	249	274	255	215

*Other hardware includes irons, putters, golf balls, golf bags, gloves, and other accessories.
Source: adidas AG annual reports, various years.

Adidas AG's Performance In 2009

At mid-year 2008, there were signs that adidas AG's corporate strategies were bringing about the hoped-for improvement in the company's financial performance. During the first six months of 2008, corporate revenues increased by 12 percent, with sales for the adidas business unit growing by 16 percent during the six-month period and sales at TaylorMade-adidas Golf growing by 11 during the first six months of 2008. Sales at Reebok declined by 2 percent during the first six months of 2008. The revenue growth and cost savings resulting from the Reebok integration allowed adidas AG's gross margins and operating margins to improve by 2.5 percentage points and 1.1 percentage points, respectively, during the first half of 2008. Earnings per share increased by 25 percent during the first half of 2008 and the company's improvement in free cash flow allowed the company to buy back nearly 7.7 million shares at an average price of €41.35 per share. The company also used its free cash flows in 2008 to fund the acquisitions of Saxon Athletic Manufacturing for $4.2 million and Textronics for $35 million. Textronics was the developer and manufacturer of wearable sensors used for fitness and health monitoring, and Saxon Athletic designed, manufactured, and marketed team uniforms worn by various sports teams throughout North America.

However, the effects of the international recession had severely damaged the company's 2009 performance and raised concerns about the long-term effectiveness of its 2005–2006 corporate restructuring plan. The company's total revenues during the first six months of 2009 declined by 7 percent when compared to the same period in 2008, and its net income for the six-month period declined by 95 percent when compared to the first six months of 2008. Sales during the first half of 2009 declined in all geographic regions except Latin America, with sales in North America declining by 10 percent, sales in Europe declining by 8 percent, and sales in Asia falling by 9 percent. Total revenues in Latin America increased by 24 percent during the first six months of 2009. Adidas-branded apparel and footwear remained the strength of the company's portfolio, with operating profits increasing by 7.2 percent between the second quarter of 2008 and the second quarter of 2009. Operating profits at TaylorMade-adidas Golf fell by 89 percent between the first half of 2008 and the first half of 2009 and the company's Reebok division recorded operating losses of nearly €150 million during the first six months of 2009. Adidas management expected its ongoing restructuring efforts would result in cost savings of €100 million by year-end 2009.

Endnotes

[1] As quoted in "Reebok and adidas: A Good Fit," *BusinessWeek Online,* August 4, 2005.

[2] As quoted in "The Brothers Dassler Fight On," *Deutsche Welle,* dw-world.de.

[3] As quoted in "Sporting Goods Consolidation off to the Races," *Mergers & Acquisitions Report,* November 10, 1997.

[4] As quoted in "Sports Goods/Shareholders Criticize Salomon Takeover," *Handesblatt,* May 21, 1999.

[5] As quoted in "Reebok and adidas: A Good Fit."

[6] Ibid.

Case 12

Robin Hood

Joseph Lampel
New York University

It was in the spring of the second year of his insurrection against the High Sheriff of Nottingham that Robin Hood took a walk in Sherwood Forest. As he walked he pondered the progress of the campaign, the disposition of his forces, the Sheriff's recent moves, and the options that confronted him.

The revolt against the Sheriff had begun as a personal crusade. It erupted out of Robin's conflict with the Sheriff and his administration. However, alone Robin Hood could do little. He therefore sought allies, men with grievances and a deep sense of justice. Later he welcomed all who came, asking few questions and demanding only a willingness to serve. Strength, he believed, lay in numbers.

He spent the first year forging the group into a disciplined band, united in enmity against the Sheriff and willing to live outside the law. The band's organization was simple. Robin ruled supreme, making all important decisions. He delegated specific tasks to his lieutenants. Will Scarlett was in charge of intelligence and scouting. His main job was to shadow the Sheriff and his men, always alert to their next move. He also collected information on the travel plans of rich merchants and tax collectors. Little John kept discipline among the men and saw to it that their archery was at the high peak that their profession demanded. Scarlock took care of the finances, converting loot to cash, paying shares of the take, and finding suitable hiding places for the surplus. Finally, Much the Miller's son had the difficult task of provisioning the ever-increasing band of Merrymen.

The increasing size of the band was a source of satisfaction for Robin, but also a source of concern. The fame of his Merrymen was spreading, and new recruits were pouring in from every corner of England. As the band grew larger, their small bivouac became a major encampment. Between raids the men milled about, talking and playing games. Vigilance was in decline, and discipline was becoming harder to enforce. "Why," Robin reflected, "I don't know half the men I run into these days."

The growing band was also beginning to exceed the food capacity of the forest. Game was becoming scarce, and supplies had to be obtained from outlying villages. The cost of buying food was beginning to drain the band's financial reserves at the very moment when revenues were in decline. Travelers, especially those with the most to lose, were now giving the forest a wide berth. This was costly and inconvenient to them, but it was preferable to having all their goods confiscated.

Robin believed that the time had come for the Merrymen to change their policy of outright confiscation of goods to one of a fixed transit tax. His lieutenants strongly resisted this idea. They were proud of the Merrymen's famous motto: "Rob the rich and give to the poor." "The farmers and the townspeople," they argued, "are our most important allies. How can we tax them, and still hope for their help in our fight against the Sheriff?"

Robin wondered how long the Merrymen could keep to the ways and methods of their early days. The Sheriff was growing stronger and becoming better organized. He now had the money and the men and was beginning to harass the band, probing for its weaknesses. The tide of events was beginning to turn against the Merrymen. Robin felt that the campaign must be decisively concluded before the Sheriff had a chance to deliver a mortal blow. "But how," he wondered, "could this be done?"

Robin had often entertained the possibility of killing the Sheriff, but the chances for this seemed increasingly remote. Besides, killing the Sheriff might satisfy his personal thirst for revenge, but it would not improve the situation. Robin had hoped that the perpetual state of unrest, and the Sheriff's failure to collect taxes, would lead to his removal from office. Instead, the Sheriff used his political connections to obtain reinforcement. He had powerful friends at court and was well regarded by the regent, Prince John.

Prince John was vicious and volatile. He was consumed by his unpopularity among the people, who wanted the imprisoned King Richard back. He also lived in constant fear of the barons, who had first given him the regency but were now beginning to dispute his claim to the throne. Several of these barons had set out to collect the ransom that would release King Richard the Lionheart from his jail in Austria. Robin was invited to join the conspiracy in return for future amnesty. It was a dangerous proposition. Provincial banditry was one thing, court intrigue another. Prince John had spies everywhere, and he was known for his vindictiveness. If the conspirators' plan failed, the pursuit would be relentless, and retributions swift.

The sound of the supper horn startled Robin from his thoughts. There was the smell of roasting venison in the air. Nothing was resolved or settled. Robin headed for camp promising himself that he would give these problems his utmost attention after tomorrow's raid.

Case 13

Walmart Stores Inc. in 2008: Management's Initiatives to Transform the Company and Curtail Walmart Bashing

ArthurA. Thompson
TheU niversityo fAl abama

In June 2008, Walmart's CEO, H. Lee Scott, presented a glowing report to the estimated 16,000 shareholders attending the company's annual shareholder meeting held at the 19,000-seat Bud Walton Arena on the University of Arkansas campus, located a few miles from Walmart's headquarters in Bentonville, Arkansas. In the tradition of prior annual meetings of Walmart shareholders, the 2008 meeting was an elaborate event lasting most of the day; the meeting included not only a series of presentations by company executives but also entertainment by Tim McGraw, David Cook (who had been named the 2008 American Idol a few weeks earlier), British singer Joss Stone, and Oscar winner and Idol finalist Jennifer Hudson. Scott said he was quite pleased with the results of the transformation process that top management had initiated in 2006 to provide customers with a more satisfying shopping experience, better fulfill the company's new mission, and do a better job of getting Walmart's 2.1 million employees worldwide to understand and practice the cultural values and business principles espoused by the company's esteemed founder, Sam Walton.

Scott explained to shareholders why transformation had become essential to the company's continued growth and success even though in 2006 Walmart's traditional business model of driving costs out of its supply chain, constantly implementing ways to operate more cost-efficiently, offering customers worldwide a broad range of merchandise at appealingly low prices, and opening stores in more and more places to serve an ever-growing customer base had served the company well:

> It would be easy to take comfort in the success we have had in our business. . . . If you know that something works, why not just replicate it and replicate it and replicate it? Well, we have done that before. For several years, we did what we knew worked. And we did it very well. We grew beyond expectations. Our stock price went up. And we felt good about it. And we had every right to.
>
> But, in time, the world changed. People's expectations of us—and of corporations in general—changed. And we found ourselves playing catch-up. We can never let that happen again. Not only must we never fall behind . . . we must always push ourselves to stay ahead.
>
> We must continue to ask fundamental questions that alter perspectives and ultimately behavior. Questions like: How do you persuade someone in a successful organization that real change is needed and can be achieved in a way that is consistent with

their core beliefs? How do you get a leadership team to step back and ask what success means not just in their own business, but in the larger context of the company as a whole? How do you take the trends of the future and put them into the business, so a company is relevant to today's consumers and well positioned for tomorrow's consumers?

These are not easy questions to ask. They are not easy questions to answer. But we have to keep asking them. And when necessary make difficult decisions.

Your Walmart has an opportunity to be a leader in the retail industry for more ethical and environmentally friendly sourcing. Your Walmart can play a role in reducing the world's dependence on oil and other high-carbon sources of energy. Your Walmart can bring even greater value to customers who need and deserve to save on everyday needs.

And there are things we need to do inside our company—such as making your Walmart more diverse and creating a more inclusive environment. I am confident that if we put diversity and inclusion into our business and really commit to it, we can make real progress. I am determined Walmart will do this. It is essential to attracting and keeping the best possible people and staying relevant to our customers. [In 2008, as Scott delivered his remarks, Walmart was already a decidedly diverse employer. Its workforce included more than 154,000 Hispanics; 237,000 African Americans; 41,000 Asian Americans; 15,000 Native Americans; 826,000 women; and 256,000 people age 55 or older.]

But I also urge you to think about what we can do—and what the world will expect us to do in the future. There are very clear trends that the retail industry and the world will have to confront—the aging of the global population, a multi-polar balance of power, income inequality, the disruptive power of technology, increased demand for energy, to name a few.

Think about these trends, the strengths of your Walmart and our model of "Saving Money" and "Living Better." We have the best global footprint to serve millions worldwide who will want the opportunity to lift themselves up into the middle class. Our leadership in sustainability will give customers and suppliers everywhere the ability to be more energy efficient and therefore more energy independent. An older global population will need us to help them stretch their money and maintain their quality of life while living on a fixed income. Here's the bottom line for our business and the larger role we can play. . . . Your Walmart is uniquely positioned to succeed not just in this economy, but in these times. And among retailers, we are the best positioned to lead in the world of tomorrow.

So how do we continue to turn our position of strength into leadership for the future? I want to repeat a quote from Sam [Walton] that I shared on this stage two years ago: "You can't just keep doing what works one time. Everything around you is always changing. To succeed, stay out in front of that change."

The world has become too complex and changes too rapidly for a company of our size to just replicate. I am not saying that we have to constantly reinvent ourselves. We do not. And we should not. We have a culture, a mission, and core values that are timeless and universal. But we have to constantly look at how we apply those things to the changing world around us. The challenge ahead is that we must continue to challenge ourselves.

I am confident that your Walmart will continue to transform. And I am confident we will continue to succeed.[1]

Scott's leadership of the transformation process under way at Walmart included a number of initiatives:

- *Recasting the company's mission as one of "Saving People Money So They Can Live Better."* "Saving money" had always been a fundamental component of what Walmart was all about—for decades, the front of every Walmart store had signage touting "We Sell for Less" and its everyday low prices were unmatched by any other retailer. But the new "Live Better" piece of Walmart's mission was, in Scott's view, a way to "unlock the full potential of Walmart" and "strengthen our ability not only to do well as a business . . . but also to do good in the world."[2]
- *Revising Walmart's logo* to better mirror the company's shift in emphasis away from

"Always low prices. Always." and "We Sell for Less" to the broader mission of "Saving People Money So They Can Live Better."

- *Making a special effort to convince Walmart's 2.1 million associates why the company's new mission was more than a hollow statement and a reflection of the company's new marketing campaign tied to the theme* "Save Money. Live Better." Scott and Walmart's other senior executives believed the new mission would not have the desired transformational effect unless it led to better operating practices and a cultural energy that actually delivered added value to customers and touched the communities in which Walmarto perated.
- *Broadening Walmart's appeal to existing customers and attracting new customers to shop at Walmart, updating merchandise offerings, instituting faster checkout procedures, and revising the layout and decor of Walmart stores to enhance store ambience and better present merchandise offerings in a manner calculated to spur sales.* A sizable number of the company's apparel lines were upgraded to better appeal to shoppers looking for a bit more upscale and stylish clothing. Stores were redecorated, aisles were widened, skylights were added to improve lighting, clutter was reduced, cleanliness was improved, and inventory on shelving that was out of reach to shoppers was eliminated. Store managers and regional managers were given more authority to stock their stores with merchandise that was particularly appealing to the local population—the objective was for each store's merchandise offerings to be "locally and regionally correct." For instance, most Walmart stores stocked sports apparel and merchandise of locally popular teams, along with products that were made locally or had local appeal. Numerous Walmart Supercenters began stocking locally grown produce. According to Scott, who along with other Walmart executives toured Walmart stores every week, in 2008 the company's 6,800 stores "look better . . . they feel better and are friendliert oo."
- *Initiating a flat $4 price for the generic versions of some 200 common prescription drugs.* In 2008, this program was extended to provide a 90-day supply of certain prescription medicines for $10. Walmart estimated that its $4 prescription program had saved customers $1.1 billion in the first 20 months of the program's existence. The company also lowered the prices of some 1,000 over-the-counter drugs.
- *Increasing "green" merchandise offerings and promoting their use to customers.* One such effort entailed helping customers live better by promoting the use of superefficient compact fluorescent light bulbs. When the program was initiated in November 2006, Walmart announced a goal of selling 100 million bulbs; by early 2008, it had sold 192 million bulbs, estimated to save customers $6 billion in electricity costs and eliminate the need to build the equivalent of 3 power plants (which in turn promoted a cleaner environment and reduced carbon dioxide emissions that were said to contribute to global warming). Another effort involved stocking a wider selection of organic foods, which were all grown using sustainable agricultural methods that did not include the use of pesticides and chemical fertilizers. Walmart's tracking of customers' decisions to purchase five key eco-friendly products showed that sales increased 66 percent between April 2007 and April 2008.[3] These and other "green" initiatives being pursued by Walmart were follow-ons to Scott's public commitment in October 2005 that Walmart would henceforth take a leadership position in promoting environmental sustainability via efforts to operate all aspects of its business in a manner calculated to promote sustainability and make the earth a better place. To make the sustainability commitment a reality, Scott had appointed several new top executives to spearhead Walmart's campaign to be a good steward of the environment.

- *Launching a multifaceted "Zero Waste" campaign.* Through its Kids Recycling Challenge, Walmart worked with elementary schools in 12 states to begin recycling plastic bags—each school received $5 for each 60-gallon collection bag that students brought to their local Walmart store. In October 2007, Walmart introduced reusable shopping bags inscribed with "Paper or Plastic? Neither"; management estimated that a reusable bag could eliminate the use of 100 disposable plastic bags and, by May 2008, Walmart had sold enough of the reusable shopping bags to eliminate the need for 400 million plastic bags. In April 2008, as part of Earth Month, Walmart gave away 1 million reusable bags. Walmart partnered with its laundry detergent suppliers to introduce concentrated liquid laundry detergents in smaller containers and thereby save on packaging; in May 2008, Walmart announced that it had achieved its goal of selling only concentrated detergents in its U.S. and Canadian stores, estimating that over a three-year period its actions would save more than 400 million gallons of water, more than 95 million pounds of plastic resin, and more than 125 million pounds of cardboard—approximately 25 percent of the liquid laundry detergent sold in the United States was at Walmart stores. Walmart began pushing its suppliers to use biodegradable packaging; it made the use of biodegradable packaging a part of its standards for suppliers and actively began working with its 66,000 suppliers to develop more eco-friendly packaging. Walmart was engaged in both internal efforts and efforts with the trucking industry to double the fuel efficiency of its fleet of 7,200 trucks, which logged some 850 million miles annually—since 2005, efficiency had been improved by 20 percent.
- *Instituting ways to make Walmart stores both more energy efficient and supplied by 100 percent renewable energy.* Walmart began working with architects, engineers, contractors, and landscape designers to begin a long-term effort to build new stores that would reduce energy usage, reduce pollution, and conserve natural resources. Two experimental stores were built to serve as living laboratories for testing new technologies and products—in 2008, one such new technology, LED lighting, was in the process of being incorporated in Walmart stores across the United States. In 2007, Walmart opened three high-efficiency stores that used 20 percent less energy than a typical Supercenter, were constructed with recycled building materials, and had motion-sensing LED lighting, low-flow bathroom faucets, reflective white roofs, and a 100-percent integrated water-source heating, cooling, and refrigeration system. In January 2008, the first of four ultra-high-efficiency stores with additional energy-saving and environmentally friendly building features was opened. Pilot projects for solar-powered stores were under way at 22 stores in California and Hawaii. In March 2008, Walmart announced that it would begin building a series of still more efficient prototype stores that were designed for specific climates and that could make use of energy-saving innovations specific to those climates. Walmart was open to sharing its learning and experiences with all its new energy-saving stores so as to help drive energy-saving innovations in building design worldwide.
- *Making Walmart an even better place to work.* Efforts here included making every full-time and part-time Walmart associate (and their children) eligible for health insurance, improving the affordability of the various health insurance options (in terms of both monthly premiums and co-pay amounts), and revising the health insurance coverage to include security from catastrophic medical expenses (after one year of eligibility, there was no lifetime maximum for most types of expenses). Going into 2008, some

92.7 percent of Walmart's associates had some form of health insurance, up from 90.4 percent in 2006. Senior management was sensitive to the importance of providing good jobs with competitive pay and benefits. The average hourly wage for full-time Walmart associates was $10.83 in early 2008; the hourly averages were in the $11–$12 range in urban areas and states like California. A sizable fraction of the jobs at Walmart, particularly those in its retail stores, were considered entry-level jobs that required minimal skills and education. While the majority of Walmart's associates were full-time employees (defined as working 34–40 hours per week), many were students who wanted work experience and seniors looking for part-time jobs to supplement their retirement income. In January 2006, some 25,000 people applied for 325 available jobs at a new store in the Chicago area; in March 2007, there were more than 11,000 applicants for 300 job openings at a new store in Maryland; and in March 2008, there were more than 12,000 applications for 450 jobs at a new store in Decatur, Georgia. For decades, Walmart had offered company personnel good opportunities for advancement owing to an ongoing stream of new store openings and a policy of promoting from within—more than 75 percent of the managerial personnel at Walmart's stores had joined the company as hourly associates.

- *Driving growth in the company's international operations via both acquisitions of foreign retailers (whose operations could later be converted to Walmart stores) and opening newly constructed stores.* This strategic thrust was aimed at transforming Walmart into an increasingly global retailer with more and more stores in more and more countries.
- *Making a positive contribution to the quality of life in every community in which the company conducted business.* Following the Katrina disaster, the company established nine disaster distribution centers strategically located across the United States that were stocked with relief supplies needed to assist communities recover in the event of a disaster. Health clinics to treat common ailments were opened in numerous Walmart stores as a means of helping bring affordable and accessible health care to low-income people—between 30 and 40 percent of the patients at these clinics were uninsured. Walmart expected to have 400 "Clinics at Walmart" outlets by 2010; all the clinics were leased to and operated by local certified health care professionals, not Walmart personnel. Walmart was the biggest corporate cash donor in the United States, giving some $296 million to 4,000 + communities in 2007. It donated $1 million or more annually to such charitable organizations as the National Fish and Wildlife Foundation, the Special Olympics, Boys & Girls Clubs of America, the United Negro College Fund, and the Muscular Dystrophy Association.

Recent Walmart Bashing: The Reason for Scott's Transformation Initiatives

H. Lee Scott's sweeping effort to transform Walmart was, to a large degree, a thoughtfully and carefully crafted response to a loud and growing chorus of Walmart critics and a series of embarrassing incidents. During the 2003–2005 period, numerous journalists, union leaders, community activists, and so-called cultural progressives had united in a campaign to bash Walmart on a variety of fronts and turn public opinion against Walmart and its seemingly virtuous business model of relentlessly wringing cost efficiencies out of its supply chain and providing customers with everyday low prices. At the center of the crusade to cast Walmart in a bad light were Walmart Watch and Wake Up Walmart.[4] Walmart Watch was founded by Andrew Stern, president of the Service Employees International Union (SEIU). Wake Up Walmart was a project of the United Food and Commercial Workers International Union (UFCW). Walmart Watch had an e-mail utility that visitors could use to direct the recipient to anti-Walmart stories; the e-mail carried a prewritten header: "I thought you might enjoy this story from Walmart Watch, a group who is starting to expose Walmart for their bad labor standards, political corruptness and overall bad citizenship. It's getting a lot of attention in the press. Take a look."[5] The SEIU and the UFCW, along with most other unions, had for decades voiced their displeasure with Walmart's conduct on a variety of fronts.

The biggest complaint of critics was that Walmart's zealous pursuit of low costs had resulted in substandard wages and insufficient medical benefits for Walmart's U.S. employees. Others complained that Walmart sourced too much of its merchandise from Chinese suppliers, thus costing jobs for American workers and hastening the decline of the U.S. manufacturing sector. Some said the "Beast of Bentonville" was too big and too powerful. Community activists in California, New York, Vermont, Massachusetts, and several other areas were vigorously opposing the company's attempts to open big-box stores in their locales, claiming that they were unsightly and detracted from the small merchant atmosphere they wanted to preserve. Walmart's low prices tended to attract customers away from locally owned apparel shops, general stores, pharmacies, sporting goods stores, shoe stores, hardware stores, supermarkets, and convenience stores. It was common for a number of local businesses that carried merchandise similar to Walmart's lines to fail within a year or two of Walmart's arrival—this phenomenon, known as the "Walmart effect," was so potent that it had spawned sometimes fierce local resistance to the entry of a new Walmart among both local merchants and area residents wanting to preserve the economic vitality of their downtown areas.

Union leaders at the UFCW, which represented workers at many supermarket chains, were adamant in their opposition to the opening of Walmart Supercenters that had a full-sized supermarket in addition to the usual merchandise selection. The UFCW and its Wake Up Walmart organization were exerting all the pressure they could to force Walmart to raise its wages and benefits for associates to levels that would be comparable to union wages and benefits at unionized supermarket chains. A UFCW spokesperson said:

> Their productivity is becoming a model for taking advantage of workers, and our society is doomed if we think the answer is to lower our standards to Walmart's level. What we need to do is to raise Walmart to the standard we have set using the supermarket industry as an example so that Walmart does not destroy our society community by community.[6]

Walmart's labor costs were said to be 20 percent less than those at unionized supermarkets.[7] In Dallas, 20 supermarkets had closed once Walmart had saturated the area with its Supercenters. According to one source, for every Walmart Supercenter opened in the next five years, two other supermarkets would be forced to close.[8] A trade publication had estimated that Walmart's opening of more than 1,000 Supercenters in the United States in the 2004–2008 period would boost Walmart's grocery and related revenues from $82 billion to $162 billion, thus increasing its market share in groceries from 19 to 35 percent and its share of pharmacy and drugstore-related sales from 15 to 25 percent.[9]

Walmart's public image took a hit in late 2003 when federal agents arrested nearly 250 illegal immigrants who worked for companies that had contracts to clean some 61 Walmart stores in 21 states. Agents had searched a manager's office at Walmart's Bentonville headquarters and taken 18 boxes of documents relating to cleaning contractors dating back to March 2000.[10] Federal officials reportedly had wiretaps showing that Walmart officials knew the company's janitorial contractors were using illegal cleaning crews. Walmart, however, was indignant about the charges, saying that its managers had cooperated with federal authorities in the investigations for almost three years, helped agents tape conversations between some of its store managers and employees of the cleaning contractors suspected of using illegal immigrants, and revised its cleaning contracts in 2002 to include language that janitorial contractors comply with all federal, state, and local employment laws (because of the information developed in 2001), and begun bringing all janitorial work in-house because outsourcing was more expensive—at the time of the arrests, fewer than 700 Walmart stores used outside cleaning contractors, down from almost half in 2000. In March 2005, Walmart settled the charges with the Justice Department.

But Walmart was battling a class-action discrimination lawsuit filed in 2003 by six female employees claiming that management systematically discriminated against women in pay, promotions, training, and job assignments at Walmart's U.S. stores. According to data from various sources, while two-thirds of Walmart's hourly employees were women, less than 15 percent of management positions were held by women. There were also indications of pay gaps of 5–6 percent between male and female employees doing similar jobs and with similar experience levels; the pay gap allegedly widened higher up the management ladder. Female management trainees allegedly made an average of $22,371 a year, compared with $23,175 for male trainees. A second lawsuit claimed that some Walmart store managers forced employees to work beyond their shifts without pay whenever employees were unable to complete assigned tasks.

And there had been several other incidents that had resulted in unflattering publicity and hits to Walmart's public persona:

- In December 2005, Walmart became the subject of a criminal investigation in Los Angeles over how it handled merchandise classified as hazardous waste. Walmart apparently transported the materials from stores in California via a return center in Las Vegas before dumping them at a disposal site. But federal prosecutors said that violated the U.S. Resource Conservation and Recovery Act. Instead of stopping by the return center in Vegas, the materials should have gone straight to the disposals ite.
- Walmart was ordered to compensate a number of former employees in Canada after it was ruled that the retail giant closed a store as a reprisal against unionization attempts. In Colorado, the UFCW had accused Walmart of harassing workers to keep them from joining its local in Denver and elsewhere; the number of such complaints had grown in recent years.
- A Walmart board member, a high-level executive, and two Walmart associates were dismissed following an internal investigation of improper expense account charges, improper payment of third-party invoices, and improper use of gift cards (some of which, according to critics, entailed efforts to finance anti-union activities and defeat unionization efforts at various Walmart stores).
- Walmart had to temporarily stop selling guns at its 118 stores across California following what California's attorney general said were hundreds of violations of state laws. Investigations by California authorities revealed that six Walmart stores had released guns before the required 10-day waiting period, failed to verify buyers' identity properly, sold illegally to felons, and allowed other violations. Walmart cooperated with government officials and agreed to immediately suspend firearm sales until correction action could be taken and store associates properly trained on state firearms laws.
- In New York State, Walmart had run afoul of a 1988 toy weapons law. The toy guns Walmart sold had an orange cap at the end of the barrel but otherwise looked real, thus violating New York laws banning toy guns with realistic colors such as black or

aluminum and not complying with New York's requirement that toy guns have unremovable orange stripes along the barrel. Investigators from the state attorney general's office shopped 10 Walmarts in New York state from Buffalo to Long Island and purchased toy guns that violated the law at each of them. Walmart had sold more than 42,000 toy guns in the state.

- Critics had slammed the company for refusing to stock CDs or DVDs with parental warning stickers (mostly profanity-laced hip-hop music) and for either pulling certain racy magazines (*Maxim, Stuff,*an d *FHM*) from its shelves or obscuring their covers. They contended that Walmart made no effort to survey shoppers about how they felt about such products but rather that it responded in ad hoc fashion to complaints lodged by a relative handful of customers and by conservative outside groups.[11] Walmart had also been the only one of the top 10 drugstore chains to refuse to stock Preven, a morning-after contraceptive introduced in 1999, because company executives did not want its pharmacists to have to grapple with the moral dilemma of abortion. Moreover, Walmart's high profile had made it a lightning rod for lawsuits, including one that it discriminated against female employees and another that claimed Walmart.
- A 98-minute feature-length documentary entitled *Walmart: The High Cost of Low Price* premiered in November 2005 and bashed the company for destroying once-thriving downtowns, running local merchants out of business, paying meager wages, selling goods produced in sweatshops in third-world countries, and assorted other corporate sins. The film included testimony from ex-employees describing seedy practices as well as clips of individuals, families, and communities that had struggled to fight the company on various issues. Canadian unions had urged their 340,000 members to take time to see the documentary and, where possible, to arrange screenings at local meetings and other union events. Anti-Walmart journalists had praised the documentary. The *San Francisco Bay Guardian* said the movie "will make you fear and loathe it even more. The unscrupulous megaretailer is exposed from every angle: its devastating effect on small businesses and communities; its inadequate health care plans; its rabid antiunion stance; the racism and sexism sprinkled throughout its ranks; its blatant disregard for environmental issues; its practice of importing nearly all of its goods (churned from company sweatshops in countries like China, Bangladesh, and Honduras); and—perhaps most offensively—its faux-homespun television advertisements, which cast a golden glow on a corporation that clearly cares not for human beings, but for cold, hardc ash."[12]

Initially, H. Lee Scott and other top Walmart executives shrugged off the bad publicity and criticism and concentrated their full attention on running the business and expanding the company's operations into more countries and more communities—as Scott put it, "We would put up the sandbags and get out the machine guns."[13] But in 2004–2005, Scott started to see that all the Walmart bashing was taking a toll on the company's sales growth and throwing up roadblocks to its expansion plans. He initiated an in-depth review of the company's legal and public relations woes and concluded that Walmart ought to reach out to its critics, examine whether their concerns had merit, and seriously consider whether Walmart ought to alter some of its practices without abandoning doing things that were the keys to its success.[14] Over the next several months, he met with an assortment of environmentalists and company critics to better understand their views, learn how companies could promote environmental sustainability, and solicit their suggestions about how the company could improve. The comprehensive transformation program initiated by Scott in 2005–2006 was his response.

Company Background

Walmart's journey from humble beginnings in the 1960s as a folksy discount retailer in the boondocks of Arkansas to a global retailing juggernaut in 2008 was unprecedented among the companies of the world:

FISCAL YEAR	SALES	PROFITS	STORES
1962	$1.4 million	$112,000	9
1970	$31 million	$1.2 million	32
1980	$1.2 billion	$41 million	276
1990	$26 billion	$1 billion	1,528
2000	$153 billion	$5.3 billion	3,884
2008	$375 billion	$12.7 billion	7,262

Sales were expected to exceed $400 billion in fiscal 2009. Walmart was the largest retailer in the United States, Canada, and Mexico, as well as the world as a whole. In 2007, Walmart's sales revenues were bigger than the combined revenues of The Home Depot, Kroger, Costco, Target, and Sears and about 2.7 times the revenues of the world's second biggest retailer, France-based Carrefour. In calendar year 2006–2007, Walmart's sales grew by more than Target's total 2007 sales. A 2003 report by the prominent Boston Consulting Group concluded that "the world has never known a company with such ambition, capability, and momentum."

Just as unprecedented was Walmart's impact on general merchandise retailing and the attraction its stores had to shoppers in locations where it had stores. In 2008, nearly 180 million people per week shopped Walmart's stores in 14 countries; in the United States, the numbers averaged 127 million per week. Since the early 1990s, the company had gone from dabbling in supermarket sales to being number one in grocery retailing worldwide. In the United States, Walmart was the biggest employer in 21 states. As of June 2008, the company employed about 2.1 million people worldwide and was expanding its workforce by about 120,000 members annually.[15]

Walmart's performance and prominence in the retailing industry had resulted in numerous awards. It had been named "Retailer of the Century" by *Discount Store News,* made the *Fortune* magazine lists of "Most Admired Companies in America" (it was ranked first in 2003 and 2004 and fourth in 2005) and "100 Best Companies to Work for in America," and been included on *Financial Times*' "Most Respected in the World" list. In 2005, Walmart was ranked second on *Fortune*'s "Global Most Admired Companies" list. Walmart was number one on both the Fortune 500 list of the largest U.S. corporations and *Fortune*'s Global 500 list every year from 2002 through 2007. Walmart received the 2002 Ron Brown Award, the highest presidential award recognizing outstanding achievement in employee relations and community initiatives. In 2003, American Veterans Awards gave Walmart its Corporate Patriotism Award. Three Walmart executives were named to *Fortune*'s 2006 "50 Most Powerful Women in Business" list.

Exhibit1 provides a summary of Walmart's financial and operating performance for the 2000–2008 fiscal years. Walmart's success had made the Walton family (Sam Walton's heirs and relatives) exceptionally wealthy—in 2008, various family members controlled more than 1.7 billion shares of Walmart stock worth over $100 billion. Increases in the value of Walmart's stock over the years had made hundreds of Walmart employees, retirees, and shareholders millionaires or multimillionaires. Since 1970, when Walmart shares were first issued to the public, the company's stock had split 11 times. A 100-share investment in Walmart stock in 1970 at the initial offer price of $16.50 equated to 204,800 shares worth $12.1 million as of June 2008.

Sam Walton,F oundero f Walmart

Sam Walton graduated from the University of Missouri in 1940 with a degree in economics and took a job as a management trainee at J. C. Penney Co. His career with Penney's ended with a call to military duty in World War II. When the war was over, Walton decided to purchase a franchise and open a Ben Franklin retail variety store in Newport, Arkansas, rather than

Exhibit1

Financial and Operating Summary, Walmart Stores, Fiscal Years 2000–2008 ($ in billions, except earnings per share data)

	FISCAL YEARS ENDING JANUARY 31					
	2008	**2007**	**2006**	**2004**	**2002**	**2000**
Financial and Operating Data						
Net sales	$374.5	$345.0	$308.9	$252.8	$202.2	$156.2
Net sales increase	8.6%	11.7%	9.8%	11.6%	13.0%	18.7%
Comparable store sales increase in the United States*	2%	2%	3%	4%	6%	8%
Cost of sales	286.5	264.2	237.6	195.9	156.8	119.5
Operating, selling, general, and administrative expenses	70.3	64.0	55.7	43.9	34.3	25.2
Interest costs, net	1.8	1.5	1.2	.8	1.2	.8
Net income	12.7	11.3	11.2	9.1	6.6	5.3
Earnings per share of common stock (diluted)	$ 3.13	$ 2.71	$ 2.68	$ 2.07	$ 1.47	$ 1.19
Balance Sheet Data						
Current assets	$ 47.6	$ 47.0	$ 43.8	$ 34.2	$ 25.9	$ 23.0
Net property, plant, equipment, and capital leases	97.0	88.4	77.9	55.2	44.2	34.6
Total assets	163.5	151.6	136.2	104.9	79.3	67.3
Current liabilities	58.5	52.1	49.0	37.4	26.3	25.1
Long-term debt	29.8	27.2	26.4	17.5	15.6	13.7
Long-term obligations under capital leases	3.6	3.5	3.7	3.0	3.0	2.9
Shareholders' equity	64.6	61.6	53.2	43.6	35.2	25.9
Financial Ratios						
Current ratio	0.8	0.9	0.9	0.9	1.0	0.9
Return on assets	8.4%	8.8%	9.3%	9.7%	9.0%	10.1%
Return on shareholders' equity	21.1%	22.0%	22.9%	22.4%	20.7%	24.5%
Other Year-End Data						
Number of Wal-Mart discount stores in the United States	971	1,075	1,209	1,478	1,647	1,801
Number of Wal-Mart Supercenters in the United States	2,447	2,256	1,980	1,471	1,066	721
Number of Sam's Clubs in the United States	591	579	567	538	500	463
Number of Neighborhood Markets in the Untied States	132	112	100	64	31	7
Number of stores outside the United States	3,121	2,757	2,181	1,248	1,050	892

*Based on sales at stores open a full year that have not been expanded or relocated in the past 12 months.

Source: Walmart annual report for 2008.

return to Penney's. Five years later, when the lease on the Newport building was lost, Walton decided to relocate his business to Bentonville, Arkansas, where he bought a building and opened Walton's 5 & 10 as a Ben Franklin–affiliated store. By 1960 Walton was the largest Ben Franklin franchisee, with nine stores. But Walton was becoming concerned about the long-term competitive threat to variety stores posed by the emerging popularity of giant supermarkets and discounters. An avid pilot, he took off in his plane on a cross-country tour studying the changes in stores and retailing trends, then put together a plan for a discount store of his own because he believed deeply in the retailing concept of offering significant price discounts to expand sales volumes and increase overall profits. Walton went to Chicago to try to interest Ben Franklin executives in expanding into discount retailing; when they turned him down, he decided to go forward on his own.

The first Walmart Discount City opened July 2, 1962, in Rogers, Arkansas. The store was successful, and Walton quickly began to look for opportunities to open stores in other small towns and to attract talented people with retailing experience to help him grow the business. Although he started out as a seat-of-the-pants merchant, he had great instincts, was quick to learn from other retailers' successes and failures, and was adept at garnering ideas for improvements from employees and promptly trying them out. Sam Walton incorporated his business as Walmart Stores in 1969, with headquarters in obscure Bentonville, Arkansas—in 2005, the Walmart-related traffic into and out of Bentonville was sufficient to support daily nonstop flights from New York City and Chicago. When the company went public in 1970, it had 38 stores and sales of $44.2 million. In 1979, with 276 stores, 21,000 employees, and operations in 11 states, Walmart became the first company to reach $1 billion in sales in such a short time.

As the company grew, Sam Walton proved an effective and visionary leader. His folksy demeanor, and his talent for motivating people, combined with a very hands-on management style and an obvious talent for discount retailing, produced a culture and a set of values and beliefs that kept Walmart on a path of continuous innovation and rapid expansion. Moreover, Walmart's success and Walton's personable style of leadership generated numerous stories in the media that cast the company and its founder in a positive light. As Walmart emerged as the premier discount retailer in the United States in the 1980s, an uncommonly large cross-section of the American public came to know who Sam Walton was and to associate his name with Walmart. Regarded by many as "the entrepreneur of the century" and "a genuine American folk hero," he enjoyed a reputation as being community-spirited, a devoted family man who showed concern for his employees, demonstrated the virtues of hard work, and epitomized the American Dream. People inside and outside the company held him in high esteem.

Just before Walton's death in 1992, his vision was for Walmart to become a $125 billion company by 2000. But his handpicked successor, David D. Glass, beat that target by almost two years. Under Glass's leadership (1988–2000), Walmart's sales grew at an average annual compound rate of 19 percent, pushing revenues up from $20.6 billion to $156 billion. When Glass retired in January 2000, H. Lee Scott was chosen as Walmart's third president and CEO. In the eight years that Scott had been CEO, Walmart's sales had grown to $218 billion, more than double the revenue level the company achieved in its first 30 years.

Walmart's Strategy

The hallmarks of Walmart's strategy were a deeply ingrained dedication to cost-efficient operations, everyday low prices, multiple store formats, wide selection, a mix of both name-brand and private-label merchandise, a customer-friendly store environment, astute merchandising, limited advertising, customer satisfaction, disciplined expansion into new geographic markets, and the use of acquisitions to enter foreign country markets. Several of these elements merit further discussion.

Cost-Efficient Operations and Everyday Low Prices

From its earliest days and continuing to the present, top executives at Walmart had vigorously and successfully pursued a low-cost leadership strategy. None of the world's major retailers could match Walmart's zeal and competence in ferreting out cost savings and finding new and better ways to operate cost-efficiently. Walmart's emphasis on achieving low costs extended to each and every value chain activity—starting with all the activities related to obtaining the desired merchandise from suppliers and then proceeding to all the logistical and distribution-related activities associated with managing inventory levels and stocking the shelves of its retail stores, all the activities involving the construction and operation of its retail stores, and keeping a tight rein on the costs of selling, general, and administrative activities. The company's competencies and capabilities in keeping its costs low allowed it to sell its merchandise at or near rock-bottom prices.

While Walmart had not invented the concept of everyday low pricing, it had done a better job than any other discount retailer in executing the concept. The company was widely seen by consumers as being the general merchandise retailer with the lowest everyday prices, and its pricing strategy spilled over to cause other discount retailers to keep their prices lower than they otherwise might when one of their stores had to compete with a nearby Walmart store. An independently certified study showed that Walmart saved the average U.S. household more than $2,500 annually, counting both the direct effect on the purchases made by Walmart shoppers and the indirect effect stemming from lower prices on the part of nearby retailers to better compete with Walmart.[16] A second independent study showed that prices of grocery items at Walmart Supercenters were 5 to 48 percent below such leading supermarket chain competitors as Kroger (which used the City Market brand in the states west of the Mississippi), Safeway, and Albertson's, after making allowances for specials and loyalty cards.[17] On average, Walmart offered many identical food items at prices averaging 15 to 25 percent lower than traditional supermarkets. Warren Buffet said, "You add it all up and they have contributed to the financial well-being of the American public more than any other institution I can think of."[18]

Multiple Store Formats

In 2008, Walmart employed four different retail concepts in the United States and Canada to attract and satisfy customers' needs: Walmart discount stores, Supercenters, Neighborhood Markets, and Sam's Clubs:

- *Discount stores*—These stores ranged from 30,000 to 224,000 square feet (the average was 108,000 square feet), employed an average of 150 people, and offered as many as 80,000 different items, including family apparel, automotive products, health and beauty aids, home furnishings, electronics, hardware, toys, sporting goods, lawn and garden items, pet supplies, jewelry, housewares, prescription drugs, and packaged grocery items. Annual sales at a Walmart discount store normally ran in the $40 to $60 million range. Walmart was phasing down the number of discount stores; since 2000, the company had expanded or relocated and converted anywhere from 100 to 170 of its discount stores to the Supercenter formatan nually.
- *Supercenters*—Supercenters, which Walmart started opening in 1988 to meet a demand for one-stop family shopping, joined the concept of a general merchandise discount store with that of a full-line supermarket. They ranged from 98,000 to 246,000 square feet (the average was 187,000 square feet), employed between 200 and 500 associates, had about 36 general merchandise departments, and offered up to 150,000 different items, at least 30,000 of which were grocery products. In addition to the value-priced merchandise offered at discount stores and a large supermarket section with 30,000 + items, Supercenters contained such specialty shops as vision centers, tire and lube express centers, a fast-food restaurant, portrait studios, one-hour photo centers, hair salons, banking, and employment agencies. Typical Supercenters had annual sales in the $70–$100 million range.
- *Sam's Clubs*—A store format that Walmart launched in 1983, Sam's was a cash-and-carry, members-only warehouse that carried about 4,000 frequently used, mostly brand-name items in bulk quantities along with some big-ticket merchandise. The product lineup included fresh, frozen, and canned food products; candy and snack items; office supplies; janitorial and household cleaning supplies and paper products; apparel; CDs

and DVDs; and an assortment of big-ticket items (TVs, tires, large and small appliances, watches, jewelry, computers, camcorders, and other electronic equipment). Stores ranged from 71,000 to 190,000 square feet (the average was 132,000 square feet), with most goods displayed in the original cartons stacked in wooden racks or on wooden pallets. Many items stocked were sold in bulk (five-gallon containers, bundles of a dozen or more, and economy-size boxes). Prices tended to be 10–15 percent below the prices of the company's discount stores and Supercenters since merchandising costs and store operation costs were lower. Sam's was intended to serve small businesses, churches and religious organizations, beauty salons and barber shops, motels, restaurants, offices, schools, families, and individuals looking for great prices on large-volume quantities or big-ticket items. Annual member fees were $35 for businesses and $40 for individuals—there were more than 47 million members in 2008. Sam's stores employed about 125 people and had annual sales averaging $75 million. A number of Sam's stores were located adjacent to a Supercenter or discount store.

- *Neighborhood Markets*—Neighborhood Markets, the company's newest store format, launched in 1998, were designed to appeal to customers who just needed groceries, pharmaceuticals, and general merchandise. They were always located in markets with Walmart Supercenters so as to be readily accessible to Walmart's food distribution network. Neighborhood Markets ranged from 37,000 to 56,000 square feet (the average was 42,000 square feet), employed 80–120 people, and had a full-line supermarket and a limited assortment of general merchandise.

U.S. and Canadian customers could also purchase a broad assortment of merchandise and services online at www.walmart.com.

During 2008 and 2009, Walmart expected to open about 310 new Supercenters, 50 new Neighborhood Markets, and 50 new Sam's Clubs in the United States. Internationally, Walmart planned to spend more than $10 billion to add about 50 million square feet of retail space in 2008 and 2009. A major initiative to enter the retailing market in India was under way. Walmart expected that its international growth would outpace its domestic growth in the years to come.

Exhibit2 shows the number of Walmart stores by country as of January 31, 2008. A number of locations in the United States were underserved by Walmart stores. Inner-city sections of New York City had no Walmart stores of any kind because ample space with plenty of parking was unavailable at a reasonable price. Walmart's first Supercenter in all of California opened in March 2004, and the whole state had just 31 Supercenters in early 2008. There were only six Supercenters in Massachusetts, one in New Jersey, and five in Connecticut (versus 289 in Texas, 152 in Florida, 119 in Georgia, 99 in Tennessee, 87 in Alabama, and 86 in Missouri).

Wide Product Selection and a Mix of Name-Brand and Private-Label Merchandise

A core element of Walmart's strategy was to provide customers with such a wide assortment of products that they could obtain much of what they needed at affordable prices in one convenient place. Supercenters, which carried a broad lineup of general merchandise as well as a full selection of supermarket items, were very much a one-stop shopping experience for many consumers.

A significant portion of the merchandise that Walmart stocked consisted of name-brand nationally advertised products. But it also marketed merchandise under some 20 private-label brands and, in addition, such licensed brands as General Electric, Disney, McDonald's, and Better Homes and Gardens.

Customer-Friendly Store Environment

In all Walmart stores, efforts were made to present merchandise in easy-to-shop shelving and displays. Floors in the apparel section

Exhibit2

Walmart's Store Count, January 31, 2008

COUNTRY	DISCOUNT STORES	SUPERCENTERS	SAM'S CLUBS	NEIGHBORHOOD MARKETS
United States	971 (all states except Nebraska, South Dakota, and Wyoming)	2,447 (all states except Hawaii and Vermont)	591 (all states except Oregon and Vermont)	132 (in 15 states)

	NUMBER OF STORES	STORE FORMATS AND BRAND NAMES
Argentina	21	20 Supercenters and 1 combination discount and grocery store (Changomas)
Brazil	313	29 Supercenters; 21 Sam's Clubs; 70 hypermarkets (Hiper Bompreco, Big); 158 supermarkets (Bompreco, Mercadorama, Nacional); 13 cash-and-carry stores (Maxxi Alacado); 21 combination discount and grocery stores (Todo Dia); and 1 general merchandise store (Magazine)
Canada	305	31 Supercenters, 268 discount stores, 6 Sam's Clubs
China	202	96 Supercenters, 2 Neighborhood Markets, 3 Sam's Clubs, 101 hypermarkets (Trust-Mart)
Costa Rica	154	6 hypermarkets (Hiper Mas), 28 supermarkets (Más por Menos), 9 warehouse stores, (maxi Bodega), and 111 discount stores (Despensa Familiar)
El Salvador	70	2 hypermarkets (Hiper Piaz), 32 supermarkets (La Despensa de Don Juan), and 36 discount stores (Despensa Familiar)
Guatemala	145	6 hypermarkets (Hiper Piaz), 28 supermarkets (Piaz), 12 warehouse stores (Maxi Bodega), 2 membership clubs (Club Co), and 97 discount stores (Despensa Familiar)
Honduras	47	1 hypermarket (Hiper Piaz), 7 supermarkets (Piaz), 7 warehouse stores (Maxi Bodega), and 32 discount stores (Despensa Familiar)
Japan	394	114 hypermarkets (Livin, Seiyu), 276 supermarkets (Seiyu, Sunny), and 4 general merchandise stores (Seiyu)
Mexico	1,023	136 Supercenters; 83 Sam's Clubs; 129 supermarkets (Superama, Mi Bodega); 246 combination discount and grocery stores (Bodega); 76 department stores (Suburbia); 349 restaurants; and 4 discount stores (Mi Bodega Express)
Nicaragua	46	6 supermarkets (La Unión) and 40 discount stores (Pali)
Puerto Rico	54	6 Supercenters, 8 discount stores, 9 Sam's Clubs, and 31 supermarkets (Amigo)
United Kingdom	352	29 Supercenters (Asda); 298 supermarkets (Asda, Asda Small Town); 13 general merchandise stores (Asda Living); and 12 apparel stores (George)—the apparel stores were scheduled to be closed in 2008

Source: Walmart's 2008 annual report., p. 51.

were carpeted to make the department feel homier and to make shopping seem easier on customers' feet. Lighting was designed to create a soft, warm impression. Signage indicating the location of various departments was prominent. Store layouts were constantly scrutinized to improve shopping convenience and make it easier for customers to find items. Store associates wore blue vests with the tag line "How May I Help You?" on the back to make it easier for customers to pick them out from a distance. Yet nothing about the decor conflicted with Walmart's low-price image; retailing consultants considered Walmart as being adept at sending out an effective mix of vibes and signals concerning customer service, low prices, quality merchandise, and friendly shopping environment. Walmart's management believed that the attention paid to all the details of making the stores more user-friendly and inviting caused shoppers to view Walmart in a more positive light.

AstuteM erchandising

Walmart was unusually active in testing and experimenting with new merchandising techniques. From the beginning, Sam Walton had been quick to imitate good ideas and merchandising practices employed by other retailers. According to the founder of Kmart, Sam Walton "not only copied our concepts; he strengthened them. Sam just took the ball and ran with it."[19] Walmart prided itself on its "low threshold for change," and much of management's time was spent talking to vendors, employees, and customers to get ideas for how Walmart could improve. Suggestions were actively solicited from employees. Most any reasonable idea was tried; if it worked well in stores where it was first tested, then it was quickly implemented in other stores. Experiments in store layout, merchandise displays, store color schemes, merchandise selection (whether to add more upscale lines or shift to a different mix of items), and sales promotion techniques were always under way. Walmart was regarded as an industry leader in testing, adapting, and applying a wide range of cutting-edge merchandising approaches. In 2005–2006, Walmart began upgrading the caliber of the merchandise it stocked in certain departments so as to be more competitive with Target, its major rival in discount retailing.

Limited Advertising

Walmart relied less on advertising than most other discount chains. The company distributed only one or two circulars per month and ran occasional TV ads, relying primarily on its widely known reputation and word of mouth to generate store traffic. Walmart's advertising expenditures ran about 0.3 percent of sales revenues, versus around 1.5 percent for Kmart and 2.3 percent for Target. Walmart's spending for radio and TV advertising was said to be so low that it didn't register on national ratings scales. Most Walmart broadcast ads appeared on local TV and local cable channels. The company often allowed charities to use its parking lots for their fund-raising activities. Walmart did little or no advertising for its Sam's Club stores; however, in 2008, Walmart did put a four-page color brochure insert in local newspapers that included a printed invitation giving anyone (including nonmembers) the ability to shop at their local Sam's Club during Sam's special 25th Anniversary Open House celebration on April 18–20.

Disciplined Expansion into New Geographic Markets

One of the most distinctive features of Walmart's domestic strategy in its early years was the manner in which it expanded into new geographic areas. Whereas many chain retailers achieved regional and national coverage quickly by entering the largest metropolitan centers before trying to penetrate less populated markets, Walmart always expanded into adjoining geographic areas, saturating each area with stores before moving into new territory. New stores were usually clustered within 200 miles of an existing distribution center so that deliveries could be made cost-effectively on a daily basis; new distribution centers were added as needed to support store expansion into additional areas. In the United States, the really unique feature of Walmart's geographic strategy had involved opening stores in small towns surrounding a targeted metropolitan area before moving into the metropolitan area itself—an approach Sam Walton had termed "backward expansion." Walmart management believed that any town with a shopping area population of 15,000 or more was big enough to support a Walmart discount store and that towns of 25,000 could support a Supercenter. Once stores were opened in towns around the most populous city, Walmart would locate one or more stores in the metropolitan area and begin major market advertising. By clustering new stores in a relatively small geographic area, the company's advertising expenses for breaking into a new market could be shared across all the area stores, a tactic Walmart used to keep its advertising costs under 1 percent of sales.

The Use of Acquisitions to Expand into Foreign Markets

In recent years, Walmart had been driving hard to expand its geographic base of stores outside the United States largely through acquisition and partly through new store construction. Walmart's entry into Canada, Mexico, Brazil, Japan, Puerto Rico, China, Germany, South Korea, and Great Britain had been accomplished by acquiring existing general merchandise or supermarket chains. Many of the acquired stores still operated under their former names (see Exhibit 2), and in most countries Walmart was being cautious in rebranding them as Walmart stores. In August 2007, Walmart and India-based Bharti Enterprises announced a joint venture to conduct wholesale cash-and carry and back-end supply chain management operations in India, the world's second most populous country; the first wholesale facility was scheduled to open in late 2008. Walmart's international strategy was to "remain local" in terms of the goods it merchandised, its use of local suppliers where feasible, and in some of the ways it operated. Management strived to adapt Walmart's "standard" operating practices to be responsive to local communities and cultures, the needs and merchandise preferences of local customers, and local suppliers. Most store managers and senior managers in its foreign operations were natives of the countries where Walmart operated; many had begun their careers as hourly employees. Walmart did, however, have a program where stores in different countries exchanged best practices.

Walmart's international division had fiscal 2008 sales of $90.6 billion (up 17.5 percent over fiscal 2007) and operating profits of $4.8 billion (up 21.7 percent). International sales accounted for 24.2 percent of total sales—this percentage had been rising steadily since 2000 and was expected to continue to rise in coming years. Sales at Walmart's international stores averaged about $29 million in sales per store in fiscal 2008; Walmart had more than 620,000 employees in its international operations.

Walmart's Competitors

Discount retailing was an intensely competitive business. Competition among discount retailers centered around pricing, store location, variations in store format and merchandise mix, store size, shopping atmosphere, and image with shoppers. Walmart's primary competitors were Kmart and Target. Like Walmart, Kmart and Target had stores that stocked only general merchandise as well as superstores (Super Target and Super Kmart) that included a full-line supermarket on one side of the store. Walmart also competed against category retailers like Best Buy and Circuit City in electronics; Toy "R" Us in toys; Kohl's and Goody's in apparel; and Bed, Bath, and Beyond in household goods.

Walmart's rapid climb to become the largest supermarket retailer via its Supercenters had intensified competition in the supermarket industry in the United States and Canada. Virtually all supermarkets located in communities with a Supercenter were scrambling to cut costs, narrow the price gap with Walmart, and otherwise differentiate themselves so as to retain their customer base and grow revenues. Continuing increases in the number of Walmart Supercenters meant that the majority of rival supermarkets in the United States would be within 10 miles of a Supercenter by 2010. Walmart had recently concluded that it took fewer area residents to support a Supercenter than originally thought—sales data indicated that Supercenters in sizable urban areas could be as little as four miles apart and still attract sufficient store traffic.

The two largest competitors in the warehouse club segment were Costco Wholesale and Sam's Clubs; BJ's Wholesale Club, a smaller East Coast chain, was the only other major U.S. player in this segment. In 2007, Costco had sales of $63.1 billion at 499 stores versus $44.4 billion at 591 stores for Sam's. The average Costco store generated annual revenues of $126 million, about 68 percent more than the $75 million average at Sam's. Costco, which had 52.6 million members as of May 2008, catered to affluent households with upscale tastes and located its stores in mostly urban areas. Costco was the United States' biggest retailer of fine wines ($500 million annually) and roasted chickens (100,000 a day). While its product line included food and household items, sporting goods, vitamins, and various other merchandise, its main attraction was big-ticket luxury items (diamonds and big-screen TVs) and the latest gadgets at bargain prices (Costco capped its markups at 14 percent). Costco had beaten Sam's in being the first to sell fresh meat and produce (1986 versus 1989), to introduce private-label items (1995 versus 1998), and to sell gasoline (1995 versus 1997).[20] Costco offered its workers good wages and fringe benefits: full-time hourly workers made about $40,000 a year after four years.

Internationally, Walmart's biggest competitor was Carrefour, a France-based retailer with 2007 sales of €92.2 million and nearly 15,000 stores of varying formats and sizes across much of Europe and in such emerging markets as Argentina, Brazil, Colombia, China, Indonesia, South Korea, and Taiwan. Both Walmart and Carrefour were expanding aggressively in Brazil and China, going head-to-head in an increasing number of locations. Going into 2008, Carrefour had 1,615 stores (500 of which were hypermarkets) in Asia and Latin America, with sales approximating €15.8 million.

Walmart's Approaches to Strategy Execution

To profitably execute its everyday low price strategy, Walmart put heavy emphasis on getting the lowest possible prices from its suppliers, forging close working relationships with key suppliers in order to capture win–win cost savings throughout its supply chain, keeping its internal operations lean and efficient, paying attention to even the tiniest details in store layouts and merchandising, making efficient use of state-of-the art technology, and nurturing a culture that thrived on pleasing customers, hard work, constant improvement, and passing cost-savings on to customers in the form of low prices.

Relationshipsw ithS uppliers

Walmart was far and away the biggest customer of virtually all of its 66,000 suppliers. Walmart's scale of operation (see Exhibit 3) allowed it to bargain hard with suppliers and get their bottom prices. In 2005, Walmart's requirements for personal computers for the holiday sales season were so big that Hewlett-Packard devoted 3 of its 10 plants operated by contract manufacturers to turning out products solely for Walmart. Walmart looked for suppliers that were dominant in their category (thus providing strong brand-name recognition), who could grow with the company, who had full product lines (so that Walmart buyers could both cherry-pick and get some sort of limited exclusivity on the products it chose to carry), who had the long-term commitment to R&D to bring new and better products to retail shelves, and who had the ability to become more efficient in producing and delivering what they supplied. But it also dealt with thousands of small suppliers (mom-and-pop companies, small farmers, and minority businesses) who could furnish particular items for stores in a certain geographical area. Many Walmart stores had a "Store of the Community" section that showcased local products from local producers; in addition, Walmart had set up an export office in the United States to help small and medium-sized businesses export their American-made products (especially to Walmart stores in foreign countries).

Walmart buyers literally shopped the world for merchandise suitable for the company's stores—it purchased from 61,000 U.S. suppliers and some 5,000 foreign suppliers in 40 countries in 2007; purchases from U.S. suppliers totaled $200 billion in 2005 and supported more than 3 million American jobs. Procurement personnel

Exhibit3

The Scale of Walmart's Purchases from Selected Suppliers and Its Market Shares in Selected Product Categories, 2002–2003

SUPPLIER	PERCENT OF TOTAL SALES TO WAL-MART	PRODUCT CATEGORY	WAL-MART'S U.S. MARKET SHARE*
Tandy Brands Accessories	39%	Dog food	36%
Dial	28	Disposable diapers	32
Del Monte Foods	24	Photographic film	30
Clorox	23	Shampoo	30
Revlon	20–23	Paper towels	30
RJR Tobacco	20	Toothpaste	26
Procter & Gamble	17	Pain remedies	21
		CDs, DVDs, and videos	15–20
		Single-copy sales of magazines	15

Although sales percentages were not available, Wal-Mart was also the biggest customer of Disney, Campbell Soup, Kraft, and Gillette

Although market shares were not available, Wal-Mart was also the biggest seller of toys, guns, detergent, video games, socks, and bedding.

*Based on sales through food, drug, and mass merchandisers.

Sources: Jerry Useem, "One Nation Under Wal-Mart," *Fortune,* March 3, 2003, p. 66, and Anthony Bianco and Wendy Zellner, "Is Wal-Mart Too Powerful?" *BusinessWeek,* October 6, 2003, p. 102.

spent a lot of time meeting with vendors and understanding their cost structure. By making the negotiation process transparent, Walmart buyers soon learned whether a vendor was doing all it could to cut down its costs and quote Walmart an attractively low price. Walmart's purchasing agents were dedicated to getting the lowest prices they could, and they did not accept invitations to be wined or dined by suppliers. The marketing vice president of a major vendor told *Fortune* magazine:

> They are very, very focused people, and they use their buying power more forcefully than anybody else in America. All the normal mating rituals are verboten. Their highest priority is making sure everybody at all times in all cases knows who's in charge, and it's Walmart. They talk softly, but they have piranha hearts, and if you aren't totally prepared when you go in there, you'll have your ass handed to you.[21]

All vendors were expected to offer their best price without exception; one consultant that helped manufacturers sell to retailers observed, "No one would dare come in with a half-ass price."[22]

Even though Walmart was tough in negotiating for absolute rock-bottom prices, the price quotes it got were still typically high enough to allow suppliers to earn a profit. Being a Walmart supplier generally meant having a stable, dependable sales base that allowed the supplier to operate production facilities cost-effectively. Moreover, once it decided to source from a vendor, then Walmart worked closely with the vendor to find *mutually beneficial* ways to squeeze costs out of the supply chain. Every aspect of a supplier's operation got scrutinized—how products got developed, what they were made of, how costs might be reduced, what data Walmart could supply that would be useful, how sharing of data online could prove beneficial, and so on. Nearly always, as they went through the process with Walmart personnel, suppliers saw ways to prune costs or otherwise streamline operations to enhance profit margins.

In 1989, Walmart became the first major retailer to embark on a program urging vendors to develop products and packaging that would not harm the environment. In addition, Walmart expected its vendors to contribute ideas about how to make its stores more fun insofar as their products were concerned. Those suppliers that were selected as "category managers" for such product groupings as lingerie, pet food, and school supplies were expected to educate Walmart on everything that was happening in their respective product category.

Some 200 vendors had established offices in Bentonville to work closely with Walmart on a continuing basis—most were in an area referred to locally as "Vendorville." Vendors were encouraged to voice any problems in their relationship with Walmart and to become involved in Walmart's future plans. Top-priority projects ranged from using more recyclable packaging to working with Walmart on merchandise displays and product mix to tweaking the just-in-time ordering and delivery system to instituting automatic reordering arrangements to coming up with new products with high customer appeal. Most recently, one of Walmart's priorities was working with vendors to figure out how to localize the items carried in particular stores and thereby accommodate varying tastes and preferences of shoppers in different areas where Walmart had stores. Most vendor personnel based in Bentonville spent considerable time focusing on which items in their product line were best for Walmart, where they ought to be placed in the stores, how they could be better displayed, what new products ought to be introduced, and which ones ought to be rotated out.

A 2007 survey conducted by Cannondale Associates found that manufacturers believed Walmart was the overall best retailer with which to do business—the ninth straight year in which Walmart was ranked number one.[23] Target was ranked second, and Costco was ranked third. The criteria for the ranking included such factors as clearest company strategy, store branding, best buying teams, most innovative consumer marketing/merchandising, best supply chain management practices, overall business fundamentals, and best practice management of individual product categories. One retailing consultant said, "I think most [suppliers] would say Walmart is their most profitable account."[24] While this might seem surprising because of Walmart's enormous bargaining clout, the potentially greater profitability of selling to Walmart stemmed from the practices of most other retailers to demand that suppliers pay sometimes steep slotting fees to win shelf space and their frequent insistence on supplier payment of such "extras" as in-store displays, damage allowances, handling charges, penalties for late deliveries, rebates of one kind or another, allowances for advertising, and special allowances on slow-moving merchandise that had to be cleared out with deep price discounts. Further, most major retailers expected to be courted with Super Bowl tickets, trips to the Masters Golf tournament, fancy dinners at conventions and trade shows, or other perks in return for their business. All of these extras represented costs that suppliers had to build into their prices. At Walmart, everything was boiled down to one price number and no "funny-money" extras ever entered into the deal.[25]

Most suppliers viewed Walmart's single bottom-line price and its expectation of close coordination as a win–win proposition, not only because of the benefits of cutting out all the funny-money costs and solidifying their relationship with a major customer but also because what they learned from the collaborative efforts and mutual data sharing often had considerable benefit in the rest of their operations. Many suppliers, including Procter & Gamble, liked Walmart's supply chain business model so well that they had pushed their other customers to adopt similar practices.[26]

Walmart's Standards for Suppliers

In 1992 Walmart began establishing standards for its suppliers, with particular emphasis on suppliers located in foreign countries that had a history of problematic wages and working conditions. Management believed that the manner in which suppliers conducted their business regarding the hours of work required of workers daily and weekly, the use of child labor, discrimination based on race or religion or other factors, and workplace safety and whether suppliers complied with local laws and regulations could be attributed to Walmart and affect its reputation with customers and shareholders. To mitigate the potential for Walmart to be adversely affected by the manner in which its suppliers conducted their business, Walmart had established a set of supplier standards and set up an internal group to see that suppliers were conforming to the ethical standards and business practices stated in its published standards. The company's supplier standards had been through a number of changes as the concerns of Walmart management evolved over time.

In February 2003, Walmart took direct control of foreign factory audits; factory certification teams based in China, Singapore, India, United Arab Emirates, and Honduras were staffed with more than 200 Walmart employees dedicated to monitoring foreign factory compliance with the company's supplier standards. Training and compliance sessions were held regularly with foreign suppliers at various locations around the world. All suppliers were asked to sign a document certifying their compliance with the standards and were required to post a version of the supplier standards in both English and the local language in each production facility servicing Walmart. In 2006, Walmart conducted 16,700 audits at 8,873 plants of suppliers; 26 percent of the audits conducted were unannounced. Walmart worked closely with suppliers to correct any violations; supplier factories that failed to correct serious violations were permanently banned from producing merchandise sold by Walmart (0.2 percent of the foreign factories failed Walmart's auditing of their operations in both 2005 and 2006 and were permanently banned; an additional 2.1 percent in 2006 and 0.1 percent in 2005 were banned for one year after re-audits found insufficient progress in correcting prior audit violations that were deemed significant).

Walmart's Use of Cutting-Edge Technology

Walmart's approach to technology was to be on the offense—probing, testing, and then deploying the newest equipment, retailing techniques, computer software programs, and related technological advances to increase productivity and drive costs down. Walmart was typically a first-mover among retailers in upgrading and improving its capabilities as new technology was introduced. The company's technological goal was to provide employees with the tools to do their jobs more efficiently and to make better decisions.

Walmart began using computers to maintain inventory control on an item basis in distribution centers and in its stores in 1974. In 1981, Walmart began testing point-of-sale scanners and then committed to systemwide use of scanning bar codes in 1983—a move that resulted in 25–30 percent faster checkout of customers. In 1984, Walmart developed a computer-assisted merchandising system that allowed the product mix in each store to be tailored to its own market circumstances and sales patterns. Between 1985 and 1987, Walmart installed the nation's largest private satellite communication network, which allowed two-way voice and data transmission between headquarters, the distribution centers, and the stores and one-way video transmission from Bentonville's corporate offices to distribution centers and to the stores; the system was less expensive than the previously used telephone network. The video system was used regularly by company officials to speak directly to all employees at once.

In 1989, Walmart established direct satellite links with about 1,700 vendors supplying close to 80 percent of the goods sold by Walmart; this link-up allowed the use of electronic purchase orders and instant data exchanges. Walmart had also used the satellite system's capabilities to develop a credit card authorization procedure that took 5 seconds, on average, to authorize a purchase, speeding up credit checkout by 25 percent compared to the prior manual system. In the early 1990s, through pioneering collaboration with Procter & Gamble, it instituted an automated reordering system that notified suppliers as their items moved though store checkout lanes; this allowed suppliers to track sales and inventories of their products (so they could plan production and schedule shipments accordingly).

By 2003, the company had developed and deployed sophisticated information technology (IT) systems and online capability that not only gave it real-time access to detailed figures on most any aspect of its operations but also made it a leader in cost-effective supply chain management. It could track the movement of goods through its entire value chain—from the sale of items at the cash register backward to stock on store shelves, in-store backup inventory, distribution center inventory, and shipments en route. Moreover, Walmart had collaborated with its suppliers to develop data-sharing capabilities aimed at streamlining the supply of its stores, avoiding both stock-outs and excess inventories, identifying slow-selling items that might warrant replacement, and spotting ways to squeeze costs out of the supply chain. The company's Retail Link system allowed 30,000 suppliers to track their wares through Walmart's value chain, get hourly sales figures for each item, and monitor gross margins on each of their products (Walmart's actual selling price less what it paid the supplier).

In mid-2003, in another of its trend-setting moves, Walmart informed its suppliers that they had to convert to electronic product code (EPC) technology based on radio frequency identification (RFID) systems. Electronic product codes involved embedding every single item that rolled off a manufacturing line with an electronic tag containing a unique number. EPC tags could be read by radio frequency scanners when brought into range of a tag reader, thus providing the ability to locate and track items throughout the supply chain in real time. With EPC and RFID capability, every single can of soup or DVD or screwdriver in Walmart's supply chain network or on its store shelves could be traced back to when it was made, where and when a case or pallet of goods arrived, and where and when an item was sold or turned up missing. Further, EPC codes linked to an online database provided a secure way of sharing product-specific information with supply chain partners. Walmart management believed EPC technology, in conjunction with the expanding production of RFID capable printers/encoders, had the potential to revolutionize the supply chain by providing more accurate information about product movement, stock rotation, and inventory levels; it was also seen as a significant tool for preventing theft and dealing with product recalls. An IBM study indicated that EPC tagging would reduce out-of-stocks by 33 percent, while an Accenture study showed that EPC/RFID technology could boost worker productivity by 5 percent and shrink working capital and fixed capital requirements by 5 to 30 percent. In 2005, EPC/RFID technology implementation was under way for Walmart's top 200 suppliers, with some 20,000 suppliers to be involved in some way by the end of 2006 and virtually all suppliers to have RFID capabilities by 2010.

In 2008, Walmart's data center was tracking more than 700 million stock-keeping units (SKUs) weekly. The company had more than 88,000 associates engaged in logistics and information systems activities. The attention Walmart management placed on using cutting-edge technology and the astuteness with which it deployed this technology along its value chain to enhance store operations and continuously drive down costs had, over the years, resulted in Walmart being widely regarded as having the most cost-effective, data-rich IT systems of any major retailer in the world. It spent less than 1 percent of revenues on IT (far less than other retailers) and had stronger capabilities. According to Linda Dillman, Walmart's chief information officer, "The strength of this division is, we are doers and do things faster than lightning. We can implement things faster than anyone could with a third party. We run the entire world out of facilities in this area [Bentonville] at a cost that no one can touch. We'd be nuts to outsource."[27] Walmart rarely used commercial software, preferring to develop its own IT systems. So powerful had Walmart's influence been on retail supply chain efficiency that its competitors (and many other retailers as well) had found it essential to follow Walmart's lead and pursue "Wal-Martification" of their retail supplyc hains.[28]

Distribution Center Operations

In 2008, Walmart had 112 distribution centers. A distribution center served 75–100 stores (usually within a 250-mile radius) and employed anywhere from 500 to 1,000 associates. Distribution centers had as much as five miles of conveyor belts and the capability to move hundreds of thousands of cases through the center each day.

Over the past three decades, Walmart had pursued a host of efficiency-increasing actions at its distribution centers. It had been a global leader in adopting the latest technology to automate most all of the labor-intensive tasks at its distribution centers, gradually creating an ever-more-sophisticated and cost-efficient system of conveyors, bar coders, handheld computers, and other devices with the capability to quickly sort incoming shipments from manufacturers into smaller, store-specific quantities and route them to waiting trucks to be sent to stores to replenish sold merchandise. Prior to automation, bulk cases received from manufacturers had to be opened by distribution center employees and perhaps stored in bins, then picked and repacked in quantities needed for specific stores and loaded onto trucks for delivery to Walmart stores—a manual process that was error-prone and sometimes slow in filling store orders. Often, incoming goods from manufacturers being unloaded at one section of the warehouse were immediately sorted into store-specific amounts and conveyed directly onto waiting Walmart trucks headed for those particular stores—a large portion of the incoming inventory was in a Walmart distribution center an average of only 12 hours. Distribution center employees had access to real-time information regarding the inventory levels of all items in the center and used the different barcodes for pallets, bins, and shelves to pick up items for store orders. Handheld computers also enabled the packaging department to get accurate information about which items to pack for which store and what loading dock to have packages conveyed. Walmart's trendsetting use of cutting-edge retailing technologies and its best-practices leadership in logistical activities had given it operating advantages and raised the bar for not only its competitors but most other retailers as well.

The company's latest initiatives to enhance distribution and logistical efficiency were to (1) achieve full implementation of RFID systems from suppliers to distribution systems to store operations and (2) double the fuel efficiency of its truck fleet. In early 2008, because some 15,000 suppliers were deemed to be dragging their heels in implementing RFID, Walmart announced it would begin charging its Sam's Club suppliers a $2 fee for each pallet delivered without RFID tagging to select distribution centers, with the fee applying to progressively more distribution centers in upcoming periods; Walmart also said the $2 fee would gradually be increased to $3 and that RFID tagging would in upcoming months begin applying to cases and selling-unit packages on pallets.

TRUCK FLEET OPERATIONS Walmart had a fleet of 7,200+ company-owned trucks and a force of 8,000+ drivers that it used to transport goods from its 112 distribution centers to its stores. Walmart hired only experienced drivers who had driven more than 300,000 accident-free miles with no major traffic violations. Distribution centers had facilities where drivers could shower, sleep, eat, or do personal business while waiting for their truck to be loaded. A truck dispatch coordinator scheduled the dispatch of all trucks based on the available time of drivers and estimated driving time between the distribution center and the designated store. Drivers were expected to pull their truck up to the store dock at the scheduled time (usually late afternoon or early evening) even if they arrived early; trucks were unloaded by store personnel during nighttime hours, with a two-hour gap between each new truck delivery (if more than one was scheduled for the same night).

In instances where it was economical, Walmart trucks were dispatched directly to a manufacturer's facilities, picked up goods for one or more stores, and delivered them directly, bypassing the distribution center entirely. Manufacturers that supplied certain high-volume items or even a number of different items sometimes delivered their products in truckload lots directly to some or many of Walmart's stores.

Store Construction and Maintenance

Walmart management worked at getting more mileage out of its capital expenditures for new stores, store renovations, and store fixtures. Ideas and suggestions were solicited from vendors regarding store layout, aisle width, the design of fixtures, and space needed for effective displays. Walmart's store designs had open-air offices for management personnel that could be furnished economically and featured a maximum of display space that could be rearranged and refurbished easily. Because Walmart insisted on a high degree of uniformity in the new stores it built, the architectural firm Walmart employed was able to use computer modeling techniques to turn out complete specifications for 12 or more new stores a week. Moreover, the stores were designed to permit quick, inexpensive construction as well as to allow for high energy efficiency and low-cost maintenance and renovation. All stores were renovated and redecorated at least once every seven years. If a given store location was rendered obsolete by the construction of new roads and highways and the opening of new shopping locations, then the old store was abandoned in favor of a new store at a more desirable site.

In keeping with the low-cost theme for facilities, Walmart's distribution centers and corporate offices were also built economically and furnished simply. The offices of top executives were modest and unpretentious. The lighting, heating, and air-conditioning controls at all Walmart stores were connected via computer to Bentonville headquarters, allowing cost-saving energy management practices to be implemented centrally and freeing store managers from the time and worry of trying to hold down utility costs. Walmart mass-produced a lot of its displays in-house, not only saving money but also cutting the time to roll out a new display concept to as little as 30 days. It also had a group that disposed of used fixtures and equipment that could not be used at other stores via auctions at the store sites where the surplus existed—a calendar of upcoming auctions was posted on the company's Web site.

Walmart's Approacht oC ustomer Service and Creating a Pleasant Shopping Experience

Walmart tried to put some organization muscle behind its pledge of "Satisfaction Guaranteed" and do things that would make customers' shopping experience at Walmart pleasant. Store managers challenged store associates to practice what Sam Walton called "aggressive hospitality." A "greeter" was stationed at store entrances to welcome customers with a smile, thank them for shopping at Walmart, assist them in getting a shopping cart, and answer questions about where items were located. Clerks and checkout workers were trained to be courteous and helpful to customers and to exhibit a "friendly, folksy attitude." Store associates were expected to adhere to the "10-foot rule": "I promise that when I come within 10 feet of a customer, I will look them in the eye, greet them, and ask if I can be of help." Walmart management believed that friendly, helpful store associates were a strong contributor to getting customers to shop frequently at Walmart.

At the same time, Walmart worked at continuously improving customers' shopping experience. H. Lee Scott's transformation program featured a major initiative to boost the appeal of shopping at Walmart's stores. In 2005, Scott appointed Eduardo Castro-Wright, the head of Walmart Mexico, as the new chief executive of Walmart's U.S. stores division and charged him with upgrading the customer experience. Castro-Wright immediately put together a three-year plan to improve store atmosphere and make shopping at Walmart more appealing. He was particularly concerned about slow checkout lines and what he saw as cluttered merchandising tactics. His campaign included replacing high shelves to reduce shelf clutter and improve sight lines throughout the stores, widening the aisles, improving navigational signs in the stores so shoppers could find things more easily, boosting efforts to keep the store environment clean and attractive (which included a more upscale store decor), and investing in technology that speeded the checkout process. Castro-Wright, together with Walmart's buyers, also shifted their thinking about customer choice, concluding that good customer choice went beyond just providing low prices and broad selection; the new theme was to place more attention on carefully selecting products and brands that shoppers cared about. Three of the biggest merchandising mix and product choice changes involved stocking more items in faster-growing categories such as consumer electronics, including more of the biggest and best brand names in select product categories (to broaden Walmart's appeal to more upscale customers), and localizing product selection to better accommodate variations in shopper tastes and preferences from one area to another.

The Culture at Walmart in 2008

Walmart's culture in 2008 continued to be deeply rooted in Sam Walton's business philosophy and leadership style. Mr. Sam, as he was fondly referred to, was not only Walmart's founder and patriarch but also its spiritual leader—and still was in many respects. Four key core values and business principles underpinned Sam Walton's approach to managing:[29]

- Treat employees as partners, sharing both the good and bad about the company so they will strive to excel and participate in the rewards. (Walmart fostered the concept of partnership by referring to all employees as "associates," a term Sam Walton had insisted upon from the company's beginnings because it denoted a partner-like relationship.)
- Build for the future, rather than just immediate gains, by continuing to study the changing concepts that are a mark of the retailing industry and be ready to test and experiment with new ideas.
- Recognize that the road to success includes failing, which is part of the learning process rather than a personal or corporate defect or failing. Always challenge the obvious.
- Involve associates at all levels in the total decision making process.

Walton practiced these principles diligently in his own actions and insisted that other Walmart managers do the same. Up until his health failed badly in 1991, he spent several days a week visiting the stores, gauging the moods of shoppers, listening to employees discuss what was on their minds, learning what was or was not selling, gathering ideas about how things could be done better, complimenting workers on their efforts, and challenging them to come up with good ideas.

The values, beliefs, and practices that Sam Walton instilled in Walmart's culture and that still carried over in 2008 were reflected in statements made in his autobiography:

> Everytime Walmart spends one dollar foolishly, it comes right out of our customers' pockets. Everytime we save a dollar, that puts us one more step ahead of the competition—which is where we always plan to be.
>
> One person seeking glory doesn't accomplish much; at Walmart, everything we've done has been the result of people pulling together to meet one common goal. . . .
>
> I have always been driven to buck the system, to innovate, to take things beyond where they've been.
>
> We paid absolutely no attention whatsoever to the way things were supposed to be done, you know, the way the rules of retail said it had to be done.
>
> . . . I'm more of a manager by walking and flying around, and in the process I stick my fingers into everything I can to see how it's coming along. . . . My appreciation for numbers has kept me close to our operational statements, and to all the other information we have pouring in from so many different places. . . .
>
> . . . The more you share profit with your associates—whether it's in salaries or incentives or bonuses or stock discounts—the more profit will accrue to your company.

> Why? Because the way management treats the associates is exactly how the associates will then treat the customers. And if the associates treat the customers well, the customers will return again and again. . . .
>
> . . . There's no better way to keep someone doing things the right way than by letting him or her know how much you appreciate their performance.
>
> The bigger we get as a company, the more important it becomes for us to shift responsibility and authority toward the front lines, toward that department manager who's stocking the shelves and talking to the customer.
>
> We give our department heads the opportunity to become real merchants at a very early stage of the game. . . . We make our department heads the managers of their own businesses. . . . We share everything with them: the costs of their goods, the freight costs, the profit margins. We let them see how their store ranks with every other store in the company on a constant, running basis, and we give them incentives to want to win.
>
> We're always looking for new ways to encourage our associates out in the stores to push their ideas up through the system. . . . Great ideas come from everywhere if you just listen and look for them. You never know who's going to have a great idea.
>
> . . . A lot of bureaucracy is really the product of some empire builder's ego. . . . We don't need any of that at Walmart. If you're not serving the customers, or supporting the folks who do, we don't need you.
>
> You can't just keep doing what works one time, because everything around you is always changing. To succeed, you have to stay out in front of that change.[30]

Walton's success flowed from his cheerleading management style, his ability to instill the principles and management philosophies he preached into Walmart's culture, the close watch he kept on costs, his relentless insistence on continuous improvement, and his habit of staying in close touch with both shoppers and associates. It was common practice for Walton to lead cheers at annual shareholder meetings, store visits, managers' meetings, and company events. His favorite was the Walmart cheer:

> *Give me a W!*
>
> *Give me an A!*
>
> *Give me an L!*
>
> *Give me a squiggly! (Here, everybody sort of does the twist.)*
>
> *Give me an M!*
>
> *Give me an A!*
>
> *Give me an R!*
>
> *Give me a T!*
>
> *What's that spell?*
>
> *Wal-Mart!*
>
> *Whose Wal-Mart is it?*
>
> *My Wal-Mart!*
>
> *Who's number one?*
>
> *The customer! Always!*

In 2008, the Walmart cheer was still a core part of the Walmart culture and was used throughout the company at meetings of store employees, managers, and corporate gatherings in Bentonville to create a "whistle while you work" atmosphere, loosen everyone up, inject fun and enthusiasm, and get sessions started on a stimulating note. While the cheer seemed corny to outsiders, once they saw the cheer in action at Walmart, they came to realize its cultural power and significance. And much of Sam Walton's cultural legacy remained intact in 2008, most especially among the company's top decision makers and longtime managers. As a *Fortune* writer put it:

> Spend enough time inside the company—where nothing backs up a point better than a quotation from Walton scripture—and it's easy to get the impression that the founder is orchestrating his creation from theb eyond.[31]

THE THREE BASIC BELIEFS UNDERLYING THE WALMART CULTURE IN 2008 Walmart top management stressed three basic beliefs that Sam Walton had preached since1962: [32]

1. *Respect for the individual*—Management consistently drummed the theme that dedicated, hardworking, ordinary people who teamed together and who treated each other

with respect and dignity could accomplish extraordinary things. Throughout company literature, comments could be found referring to Walmart's "concern for the individual." Such expressions as "Our people make the difference," "We care about people," and "People helping people" were used repeatedly by Walmart executives and store managers to create and nurture a family-oriented atmosphere among store associates.

2. *Service to our customers*—Management always stressed that the company was nothing without its customers. To satisfy customers and keep them coming back again and again, management emphasized that the company had to offer quality merchandise at the lowest prices and do it with the best customer service possible. Customers had to trust in Walmart's pricing philosophy and to always be able to find the lowest prices with the best possible service. One of the standard Walmart mantras preached to all associates was that the customer was number one and that the customer was boss. Associates in stores were urged to observe the "10-foot rule."
3. *Strive for excellence*—The concept of striving for excellence stemmed from Sam Walton's conviction that prices were seldom as low as they needed to be and that product quality was seldom as high as customers deserved and expected. The thesis at Walmart was that new ideas and ambitious goals made the company reach further and try harder—the process of finding new and innovative ways to push boundaries and constantly improve made the company better at what it did and contributed to higher levels of customer satisfaction. Walmart managers at all levels spent much time and effort motivating associates to offer ideas for improvement, and to function as partners. It was reiterated that every cost counted and that every worker had a responsibility to be involved.

Walmart's culture had unusually deep roots at the headquarters complex in Bentonville and mirrored Sam Walton's 10 rules for building a business—see Exhibit 4. The numerous journalists and business executives who had been to Bentonville and spent much time at Walmart's corporate offices uniformly reported being impressed with the breadth, depth, and pervasive power of the company's culture. Jack Welch, former CEO of General Electric and a potent culture builder in his own right, noted that "the place vibrated" with cultural energy. There was little evidence that the culture in Bentonville was any weaker in 2008 than it had been 17 years earlier when Sam Walton personally led the culture-building, culture-nurturing effort and infused the company with unparalleled dedication to frugality, wringing every penny out of costs, and passing the savings on to customers in the form of low prices. Not only were there tireless efforts to achieve cost savings in product design, materials, packaging, labor, transportation, store construction, and store operations but Walmart associates, including executives, also flew coach, shared hotel rooms, and emptied their own trash. The philosophy was expressed as follows: "If we can go without something to save money, we do. It's the cornerstone of our culture to pass on our savings. Every penny we save is a penny in our customers' pockets."[33] But in 2008, a new cultural trait was evident in the Bentonville headquarters: The "Living Better" element of the company's new mission statement was fast becoming a core value at Walmart and an integral part of its culture and operating practices. While saving money was still the dominant value and a pervasive cultural trait, much energy and effort at headquarters was being devoted to modifying Walmart's priorities and conducting the company's business in a manner that produced "Living Better" outcomes.

But Walmart executives nonetheless were currently facing a formidable challenge in instilling a vibrant, resourceful, and dedicated Bentonville-like culture in the company's distribution centers and most especially in its stores. Annual turnover rates at Walmart stores ran as high as 40 percent in 2002–2008 and had run as high as 70 percent in 1999, when the economy

Exhibit4

Sam Walton's Rules for Building a Business

Rule 1: Commit to your business. Believe in it more than anybody else. I think I overcame every single one of my personal shortcomings by the sheer passion I brought to my work. I don't know if you're born with this kind of passion, or if you can learn it. But I do know you need it. If you love your work, you'll be out there every day trying to do it the best you possibly can, and pretty soon everybody around will catch the passion from you—like a fever.

Rule 2: Share your profits with all your Associates, and treat them as partners. In turn, they will treat you as a partner, and together you will all perform beyond your wildest expectations. Remain a corporation and retain control if you like, but behave as a servant leader in a partnership. Encourage your Associates to hold a stake in the company. Offer discounted stock, and grant them stock for their retirement. It's the single best thing we ever did.

Rule 3: Motivate your partners. Money and ownership alone aren't enough. Constantly, day-by-day, think of new and more interesting ways to motivate and challenge your partners. Set high goals, encourage competition, and then keep score. Make bets with outrageous payoffs. If things get stale, cross-pollinate; have managers switch jobs with one another to stay challenged. Keep everybody guessing as to what your next trick is going to be. Don't become too predictable.

Rule 4: Communicate everything you possibly can to your partners. The more they know, the more they'll understand. The more they understand, the more they'll care. Once they care, there's no stopping them. If you don't trust your Associates to know what's going on, they'll know you don't really consider them partners. Information is power, and the gain you get from empowering your Associates more than offsets the risk of informing your competitors.

Rule 5: Appreciate everything your Associates do for the business. A paycheck and a stock option will buy one kind of loyalty. But all of us like to be told how much somebody appreciates what we do for them. We like to hear it often, and especially when we have done something we're really proud of. Nothing else can quite substitute for a few well-chosen, well-timed, sincere words of praise. They're absolutely free—and worth a fortune.

Rule 6: Celebrate your successes. Find some humor in your failures. Don't take yourself so seriously. Loosen up, and everybody around you will loosen up. Have fun. Show enthusiasm—always. When all else fails, put on a costume and sing a silly song. Then make everybody else sing with you. Don't do a hula on Wall Street. It's been done. Think up your own stunt. All of this is more important, and more fun, than you think, and it really fools the competition. "Why should we take those cornballs at Walmart seriously?"

Rule 7: Listen to everyone in your company. And figure out ways to get them talking. The folks on the front lines—the ones who actually talk to the customer—are the only ones who really know what's going on out there. You'd better find out what they know. This really is what total quality is all about. To push responsibility down in your organization, and to force good ideas to bubble up within it, you must listen to what your Associates are trying to tell you.

Rule 8: Exceed your customers' expectations. If you do, they'll come back over and over. Give them what they want—and a little more. Let them know you appreciate them. Make good on all your mistakes, and don't make excuses—apologize. Stand behind everything you do. The two most important words I ever wrote were on that first Walmart sign, "Satisfaction Guaranteed." They're still up there, and they have made all the difference.

Rule 9: Control your expenses better than your competition. This is where you can always find the competitive advantage. For 25 years running—long before Walmart was known as the nation's largest retailer—we ranked No. 1 in our industry for the lowest ratio of expenses to sales. You can make a lot of different mistakes and still recover if you run an efficient operation. Or you can be brilliant and still go out of business if you're too inefficient.

Rule 10: Swim upstream. Go the other way. Ignore the conventional wisdom. If everybody else is doing it one way, there's a good chance you can find your niche by going in exactly the opposite direction. But be prepared for a lot of folks to wave you down and tell you you're headed the wrong way. I guess in all my years, what I heard more often than anything was: a town of less than 50,000 population cannot support a discount store for very long.

Source: www.walmartstores.com (accessed December 19, 2005).

was booming and the labor market was tight. Such high rates of turnover in a workforce that numbered 2.1 million people in 2008, coupled with net workforce increases of about 120,000 associates annually, made it a Herculean task to maintain a deeply ingrained, values-driven culture—indeed, no other company in all of business history had been confronted with having to culturally indoctrinate so many new employees in so many locations in such a relatively short time. Even though Walmart's distribution centers had lower turnover and fewer new employees to culturally train and absorb annually than the company's retail stores, Walmart's culture was much less deeply rooted in its distribution centers than in Bentonville. And the cultural traits so evident in Bentonville were shared by relatively few of the associates at Walmart's retail stores, partly or even mostly because so many store associates chose not to make a career of working at Walmart.

SolicitingI deasf rom Associates

Associates at all levels were expected to be an integral part of the process of making the company better. Walmart store managers usually spent a portion of each day walking around the store checking on how well things were going in each department, listening to associates, soliciting suggestions and discussing how improvements could be made, and praising associates who were doing a good job. Store managers frequently asked associates what needed to be done better in their department and what could be changed to improve store operations. Associates who believed a policy or procedure detracted from operations were encouraged to challenge and change it. Task forces to evaluate ideas and plan out future actions to implement them were common, and it was not unusual for the person who developed the idea to be appointed the leader of the group.

Listening to employees was a very important part of each manager's job. All of Walmart's top executives relied on management by walking around (MBWA); they visited stores, distribution centers, and support facilities regularly, staying on top of what was happening and listening to what employees had to say about how things were going. Senior managers at Walmart's Bentonville headquarters believed that visiting stores and listening to associates was time well spent because a number of the company's best ideas had come from Walmart associates—Walmart's use of people greeters at store entrances was one of those ideas.

Compensationan dB enefits

In 2007, Walmart's average hourly wage for regular full-time associates in the United States was $10.83, up from $9.68 an hour in 2005 (the federal minimum wage was raised from $5.15 to $5.85 beginning July 24, 2007; existing legislation called for the hourly minimum to increase to $6.55 beginning July 24, 2008, and to $7.25 beginning July 24, 2009). Walmart's average pay was higher in certain urban areas; for example, average hourly wages in Chicago were $11.18; in Atlanta, $11.27; and in Boston, $11.98.[34] Store clerks generally earned the lowest wage; workers who unloaded trucks and stocked store shelves could earn anywhere from $25,000 to $50,000. Part-time jobs at Walmart were most common among sales clerks and checkout personnel in the stores where customer traffic varied appreciably during days of the week and months of the year.

New hourly associates in the United States were paid anywhere from $1 to $6 above the minimum wage, depending on the type of job, and could expect to receive a raise within the first year at one or both of the semiannual job evaluations. Typically, at least one raise was guaranteed in the first year if Walmart planned to keep the individual on the staff. The other raise depended on how well the associate worked and improved during the year. In addition, every store associate was eligible to receive performance bonuses based on the performance of their store, and every hourly associate with 20 or more years of service was awarded an extra week of pay—in fiscal 2008, Walmart awarded more than $636 million in performance bonuses to its U.S. hourly associates. At the store level, only the store manager and assistant manager were salaried; all other associates, including the department managers, were considered hourly employees. Store managers generally had six-figure incomes.

A majority of Walmart's hourly store associates in the United States worked full-time—at most U.S. retailers, the percentage of employees that worked full-time ranged between 20 and 40 percent.

IMPROVING HEALTH CARE BENEFITS In 2005, about 48 percent of Walmart's associates in the United States had signed up for health insurance coverage in a Walmart-sponsored plan (compared with an average of 72 percent for the whole retailing industry). Many Walmart associates did not sign up for health coverage because another household member already had family coverage at his or her place of employment. New full-time and part-time associates became eligible for health care benefits after a six-month wait and a one-year exclusion for preexisting conditions. Worker premiums for coverage were as little $11 per month for individuals and 30 cents per day for children (no matter how many children an associate had). There were several plans that workers could choose from; usually, the lower the premium, the higher the annual deductible. There were no lifetime maximums for most expenses (a feature offered by fewer than 50 percent of employers). The health benefit package covered 100 percent of most major medical expenses above $1,750 in employee out-of-pocket expenses and entailed no lifetime cap on medical cost coverage (a feature offered by fewer than 50 percent of employers).[35] The company's health benefits in 2005 also included dental coverage, short- and long-term disability, an illness protection plan, and business travel accident insurance. But to help control its health costs for associates, Walmart's health care plan did not pay for flu shots, eye exams, child vaccinations, chiropractic services, and certain other treatments allowed in the plans of many companies; further, Walmart did not pay any health care costs for retirees.

However, during 2004–2006, critics assailed Walmart's health care offering on grounds that the coverage was skimpier than that of many employers and that far too few Walmart employees were eligible for coverage. For example, until 2005, Walmart's health insurance plan did not cover the cost of vaccinations for routine childhood diseases, and part-time employees had to work for two years before becoming eligible for coverage for themselves (family coverage was not available to part-time employees). According to 2005 data, 5 percent of Walmart associates were on Medicaid, compared to an average for national employers of 4 percent; and 27 percent of associates' children were on such programs, compared to a national average of 22 percent. In total, 46 percent of associates' children were either on Medicaid or wereu ninsured.[36]

Walmart recognized that its critics had made valid points regarding the shortcomings of the company's health care offering. Starting in January 2006, Walmart began providing health insurance to more than 1 million of its 1.7 million associates and offering up to 18 different plans. As of 2008, further improvements had been made in Walmart's health care benefits. Every associate who worked in the United States could become eligible for individual health coverage costing as little as $5 per month in some areas and as little as $8 per month nationwide; full-time employees were eligible for coverage after six months, and the two-year waiting period for part-time associates was reduced to one year. As soon as an associate became eligible for benefits, his or her spouse and children became eligible too. Associates had more than 50 ways to customize their health coverage. In the $5-per-month plan, Walmart gave each employee or family a grant of $100 to $500 to defray health expenses; an $8-per-month plan entailed a $100 health care credit and a deductible of $2,000 before medical expense coverage kicked in. In still another plan, an associate paid premiums of up to $79 a month, received a health care credit of $100, and paid a deductible of $500. Most options paid for 80 percent of eligible medical expenses incurred after the deductible was reached; however, once an associate's out-of-pocket medical expenses reached $5,000, the plans paid 100 percent of eligible charges. Some 2,400 generic drugs were available for $4; brand-name drugs cost $30 to $50. There were no lifetime maximums on most health care expenses.

OTHER BENEFITS Walmart's package of fringe benefits for full-time employees (and some part-time employees) also included the following:

- Vacation and personal time.
- Holidayp ay.
- Jury duty pay.
- Medical and bereavement leave.
- Militaryl eave.
- Maternity/paternityl eave.
- Confidential counseling services for associates and their families.
- Child care discounts for associates with children (through four national providers).
- GED reimbursement/scholarships for associates and their spouses.
- 10 percent discounts on regularly priced merchandise, fresh fruits and vegetables, and eyewear purchased at Walmart Vision Centers. (Sam's Club associates received a Sam's membership card at no cost. In fiscal 2008, Walmart contributed $420 million in discounted merchandise to hourly associates and family members.)

PROFIT-SHARING AND RETIREMENT PLANS Walmart maintained a profit-sharing plan for full-time and part-time associates in the United States; individuals were eligible after one year and 1,000 hours of service. Annual contributions to the plan were tied to the company's profitability and were made at the sole discretion of management and the board of directors. Employees could contribute up to 15 percent of their earnings to their 401(k) accounts. Walmart's contribution to each associate's profit-sharing account became vested at the rate of 20 percent per year beginning the third year of participation in the plan. After seven years of continuous employment the company's contribution became fully vested; however, if the associate left the company prior to that time, the unvested portions were redistributed to all remaining employees.

The plan was funded entirely by Walmart and most of the profit-sharing contributions were invested in Walmart's common stock. In recent years, the company's contribution to profit sharing and the 401(k) plan had averaged 4 percent of a U.S. associate's eligible pay, with total contributions amounting to $945 million in fiscal 2008, $890 million in fiscal 2007, and $827 million in fiscal 2006. Walmart's contributions to the profit-sharing and retirement plans of foreign associates totaled $267 million in fiscal 2008, $274 million in fiscal 2007, and $244 million in fiscal 2006. Associates could begin withdrawals from their account upon retirement or disability, with the balance paid to family members upon death.

STOCK PURCHASE AND STOCK OPTION PLANS A stock purchase plan was adopted in 1972 to allow eligible employees a means of purchasing shares of common stock through regular payroll deduction or annual lump-sum contribution. Prior to 1990, the yearly maximum under this program was $1,500 per eligible employee; starting in 1990, the maximum was increased to $1,800 annually. The company contributed an amount equal to 15 percent of each participating associate's contribution. Long-time employees who had started participating in the early years of the program had accumulated stock worth over $100,000. About one-fourth of Walmart's employees participated in the stock purchase plan in 1993, but this percentage had since declined, as many new employees opted not to participate. In fiscal 2008, Walmart contributed $50.1 million to the stock purchases of some 764,000 associates.

In addition to regular stock purchases, certain employees qualified to participate in stock option plans; options expired 10 years from the date of the grant and could be exercised in nine annual installments. Share-based compensation of executives and associates totaled $276 million in fiscal 2008 and $271 million in fiscal 2007.

OVERALL BENEFIT COSTS In fiscal 2005, Walmart spent $4.2 billion on benefits for its associates (equal to 1.9 percent of revenues), up from $2.8 billion in 2002 (1.5 percent of revenues). The company's benefit expenses were growing 15 percent annually due to a combination of factors: growing workforce size, increased age and average tenure of associates, and rising cost trends for benefits, particularly health care. Top management and the board of directors were actively looking at strategies to contain the rising costs of the company's fringe benefit package, while at the same time preserving employee satisfaction with the benefit package and avoiding outcries from critics. Recent surveys of associates indicated overall satisfaction with the current benefit package (although this varied by benefit and associate demographics), but there was opposition to higher deductibles. Interestingly, the least healthy, least productive employees tended to be the most satisfied with their benefits and expressed interest in longer careers with Walmart.

Training

Top management was committed to providing all associates state-of-the-art training resources and development time to help achieve career objectives. The company had a number of training tools in place, including classroom courses, computer-based learning, distance learning, corporate intranet sites, mentor programs, satellite broadcasts, and skills assessments. In November 1985, the Walton Institute of Retailing was opened in affiliation with the University of Arkansas. Within a year of its inception, every Walmart manager from the stores, the distribution facilities, and the general office were expected to take part in special programs at the Walton Institute to strengthen and develop the company's managerial capabilities.

MANAGEMENT TRAINING Walmart store managers were hired in one of three ways. Hourly associates could move up through the ranks from sales to department manager to manager of the checkout lanes to store manager—more than 65 percent of Walmart's managers had started out as hourly associates. Second, people with outstanding merchandising skills at other retail companies were recruited to join the ranks of Walmart managers. And third, Walmart recruited college graduates to enter the company's training program. Store management trainees went through an intensive on-the-job training program of almost 20 weeks and then were given responsibility for an area of the store. Trainees who progressed satisfactorily and showed leadership and job knowledge were promoted to an assistant manager, which included further training in various aspects of retailing and store operations. Given Walmart's continued store growth, above-average trainees could progress to store manager within five years. Through bonuses for sales increases above projected amounts and company stock options, the highest-performing store managers earned well into six figures annually.

ASSOCIATE TRAINING Walmart did not provide a specialized training course for its hourly associates. Upon being hired, an associate was immediately placed in a position for on-the-job training. From time to time, training films were shown in associates' meetings. Store managers and department managers were expected to train and supervise the associates under them in whatever ways were needed. As one associate put it, "Mostly you learn by doing. They tell you a lot; but you learn your job every day."

Special programs had been put in place to ensure that the company had an adequate talent pool of women and minorities who were well prepared for management positions. If company officers did not meet their individual diversity goals, their bonuses were cut 15 percent.

Walmart's Use of Meetings: A Time for Rapid Action

The company used meetings both as a communication device and as a culture-building exercise.

Store managers had several regularly scheduled meetings with store associates daily. In Bentonville, there were Thursday-afternoon meetings dealing with store operations, Friday-morning management meetings, Friday-noon merchandising meetings, and Saturday-morning meetings covering a range of topics. Most every meeting began and ended with the Walmart cheer.

STORE AND DISTRIBUTION CENTER MEETINGS Each Walmart store had a 15-minute shift-change meeting when a new group of cashiers, stockers, and supervisors arrived. Managers reviewed sales numbers for the previous day, making a point to single out (1) displays that were effective and those that needed attention and (2) products that were selling particularly well and those whose sales were lagging.[37] An assistant department manager who reported big sales of particular items was likely to receive supportive applause and cheering. Associates were nearly always asked for their suggestions about how to spur sales and improve customers' shopping experience. They quickly learned that a key to advancement at Walmart was to be a frequent and thoughtful contributor of ideas and suggestions at these meetings (as well as in conversations with their department manager and when assistant store managers and the store manager were touring their part of the store). Good ideas and suggestions were acted on immediately, with the associate responsible for the suggestion having a lead implementation role when it involved something he or she could undertake. When appropriate, store managers relayed the best ideas and suggestions on up the chain to regional vice presidents (VPs), who had responsibility over 100 or so stores and who visited each store about six times annually. The regional VPs decided which ideas and suggestions bubbling up from the stores to bring up at one of the weekly meetings in Bentonville.

The same kind of meeting cycles and solicitation of ideas from associates occurred in Walmart's 110 + distribution centers, in the Sam's Club division, and in Walmart's stores in countries outside the United States.

THE MEETINGS IN BENTONVILLE The weekly Thursday-afternoon store operations meeting, attended by about 70 people, dealt with the nuts and bolts of making the stores operate smoothly. Attendees remained standing—a tactic that kept the meeting from dragging on and prompted those speaking to make their point quickly; topics ranged from inventory management to store staffing issues to new-store real estate planning.[38] The weekly management meetings held at 7:00 a.m. on Fridays included the top 200 people in the company; outsiders were not permitted to attend, since the sometimes spirited discussions and debates involved sensitive strategic and competitive issues.[39] At both meetings, the information sharing and the ensuing discussions led to decisions about what actions needed to be taken; very rarely were issues left open for further debate and resolution at an upcoming meeting.

The weekly Friday merchandising meeting was an hour-and-a-half noontime session involving about 300 people—Walmart's buyers and merchandising staff headquartered in Bentonville and the regional vice presidents who directed store operations and were fresh back from tours of Walmart stores and, frequently, visits to the stores of the company's two closest competitors, Kmart and Target, earlier in the week. The merchandising meeting had two purposes: (1) to give the buyers a direct sense of what was and was not selling well in the stores and why and (2) to give the regional VPs a means to get instant action to resolve merchandising issues in their stores.[40] Considerable time was usually devoted to merchandising errors—having too much of a product (which prompted markdowns) and not having enough of a hot-selling item. It was also normal for the regional VPs to report on instances when they found that Walmart's prices for particular items were higher that those at either Kmart or Target and when they believed that Walmart was missing out on a hot-selling product. On one occasion, a regional VP reported that a Kmart store he had just visited was selling a $9.99 poker table cover and chip set that was a much better value than a comparable item Walmart was selling—he pulled the poker set Kmart was selling out of a Kmart bag and showed it to the group.[41] Walmart's divisional merchandising manager responded by saying, "We've got a pretty nice poker set in our stores, but I will check with our sources and get back to you." The discussion then moved to another regional VP complaining about a series of shortages of bedding and kitchen items at her stores. Then the divisional merchandising manager reported to the group that he had arranged for the poker sets sold at Kmart to be acquired and that they would be on Walmart trucks for delivery to stores the upcoming week—attendees cheered. David Glass, Walmart's former CEO, recalled what took place at the Friday merchandise meetings during his tenure:

> In retailing, there has always been a traditional, head-to-head confrontation between operations and merchandising. You know, the operations guys say, "Why in the world would anybody buy this? It's a dog, and we'll never sell it." Then the merchandising folks say, "There's nothing wrong with that item. If you guys were smart enough to display it well and promote it properly, it would blow out the doors." So we sit all these folks down together every Friday at the same table and just have at it.
>
> We get into some of the doggonedest, knock-down drag-outs you have ever seen. But we have a rule. We never leave an item hanging. We will make a decision in that meeting even if it's wrong, and sometimes it is. But when the people come out of that room, you would be hard-pressed to tell which ones oppose it and which ones are for it. And once we've made that decision on Friday, we expect it to be acted on in all the stores on Saturday. What we guard against around here is people saying, "Let's think about it." We make a decision. Then we act on it.[42]

Shortly after the conclusion of the Friday merchandise meetings, the "priorities were culled from the meeting, and buyers and regional VPs were sent a priority e-mail outlining perhaps a dozen follow-on assignments to complete by the end of the day."[43]

The Saturday-morning meetings, a Walmart ritual since 1961, were held 52 weeks a year at 7:00 a.m. sharp. Top officers and as many as 600 other people (including relatives of Walmart personnel attending the meeting and special VIP guests, frequently including celebrities with a role on the program) gathered in a 400-seat stageless auditorium and an adjoining cafeteria for a two-and-a-half-hour session that was a combination pep rally, talk show, financial report, town-hall forum, gripe session, idea exchange, business update, merchandising lesson, decision-making meeting, and morale booster.[44] Each week's agenda was deliberately designed to be interesting and important enough to cause attendees to want to be there despite the early hour. Typically, the meeting began with CEO H. Lee Scott or honored guests leading the Walmart cheer, with other attendees standing, clapping their hands, and joining in enthusiastically. The business part of the meeting featured presentations concerning how well things were going, a new company initiative, a review of the week's sales, ideas and suggestions that originated in the stores and distribution centers, new product launches and special promotion items, store construction and new store openings, distribution centers, transportation, supply chain activities, and the like. Management described the nature and purpose of the Saturday meetings as follows:

> Created with a sense of the unpredictable and intended to entertain as well as inform, the Saturday morning meeting lets everyone know what the rest of the company is up to.
>
> The agenda constantly changes, so each meeting has an element of spontaneity. Sometimes we'll bring associates from the field in to Bentonville to praise them in front of the whole meeting. Other mornings, an associate may get a standing ovation as he receives a 20-year service award.
>
> On any given Saturday, we may invite special guests to promote product launches or just to share insights. We've had CEOs of other Fortune 500 companies, musicians, actors, journalists, authors, athletes, politicians, and children's characters. . . . That kind of unpredictability keeps things interesting.
>
> But beyond focusing on giving good news, entertaining special guests, and

> having a good time, we use that valuable time to critique our business. We review what we could do better and encourage suggestions about correcting those weaknesses. If the solution is obvious, we can order changes right then and carry them out over the weekend, while almost everyone else in retail business is off.
>
> The meeting is where we discuss and debate management philosophy and strategy. It's the focal point of our communication efforts, where we share ideas. We look at what our competition is doing well and look for ways to improve upon their successes in our own business. Often, it's the place where we decide to try things that seem unattainable, and instead of shooting those ideas down, we try to figure out how to make them work.
>
> The Saturday morning meeting remains the pulse of our culture.

As at the Friday merchandise meetings, decisions were made at the Saturday-morning meetings about what actions needed to be taken. According to former CEO David Glass, "The rule of thumb was that by noon we wanted all the corrections made in the stores. Noon on Saturday."[45]

The store meetings and the Thursday-Friday-Saturday meetings in Bentonville, along with the in-the-field visits by Walmart management, created a strong bias for action. A *Fortune* reporter observed, "Managers suck in information from Monday to Thursday, exchange ideas on Friday and Saturday, and implement decisions in the stores on Monday."[46]

Walmart'sE nvironmentalS ustainability Campaign

In 2008, Walmart was fast emerging as the world's greenest retailer and a model of how companies could promote environmental sustainability by conducting their business in an eco-friendly manner. The environmental commitment at Walmart was a by-product of H. Lee Scott's efforts to combat the bad press the company was receiving in 2004–2005. In June 2004, Scott had an informal meeting with two officials from Conservation International with whom he had recently become acquainted and another environmentally oriented individual; all three argued that Walmart could improve its image, motivate employees, and save money by going green. Scott was intrigued. Shortly thereafter, he decided to hire Conservation International to measure Walmart's environmental impact. Rather quickly, Conservation International spotted ways that Walmart could cut waste, reduce excessive packaging, and improve energy efficiency—and save tens of millions of dollars in the process. Another influential consulting firm that advocated green operating practices was brought in to study how Walmart could wring more energy efficiency out of its trucking fleet. Because going green held the promise of reducing Walmart's operating costs—something always cherished at Walmart—Scott and other senior executives very quickly began pulling eco-friendly ideas from everywhere, including prominent environmental advocates, suppliers, regulators, and other eco-friendly companies like Starbucks, Patagonia, and Whole Foods.[47] Walmart set up meetings with suppliers, environmental groups, and regulators every few months to share ideas, set goals, and monitor progress. Al Gore was invited to speak at a Saturday-morning meeting, following the showing of his movie *An Inconvenient Truth;* Gore's parting thought was that there need not be any conflict between the environment and the economy.[48]

Over a period of 12–14 months, Scott came to the conclusion that Walmart should be an engaged, difference-making contributor to environmental sustainability. He told a *Fortune* reporter:

> To me, there can't be anything good about putting all these chemicals in the air. There can't be anything good about the smog you see in cities. There can't be anything good about putting chemicals in these rivers in Third World countries so that somebody can buy something for less money in a developed country. Those things are just inherently wrong whether you are an environmentalist or not.
>
> Some people say this is foreign to what Sam Walton believed. . . . What people forget is that there was nobody more willing to

> change. Sam Walton did what was right for his time. Sam loved the outdoors. And he loved the idea of building a company that would endure. I think Sam Walton would, in fact, embrace Walmart's efforts to improve the quality of life for our customers and our associates by doing what we need to do in sustainability.[49]

In October 2005, Scott gave a speech titled "Twenty-First Century Leadership" in which he committed Walmart to achieving three long-term objectives:

1. To be 100 percent supplied by renewable energy.
2. To create zero waste.
3. To sell products that sustained natural resources and the environment.

Then in a speech broadcast to all Walmart facilities in November 2005, Scott announced that Walmart would be pursuing three specific short-term objectives:

- Increase the efficiency of its truck fleet by 25 percent within three years and by 100 percent in 10 years.
- Reduce solid waste in U.S. stores by 25 percent in threeye ars.
- Reduce energy usage in stores by 30 percent.

Scott also said the company would invest $500 million in sustainability projects. A senior vice president for sustainability was appointed to spearhead and oversee Walmart's environmental sustainability strategies. A number of Walmart's critics—union leaders, environmental extremists, and ideological elites—were unimpressed. The union-funded Walmart Watch labeled Walmart's environmental push as a "high-priced green-washing campaign."[50]

But Scott's resolve was unshaken. What began as a defensive strategy soon became something of a crusade. Pursuing ways to save money was a company strength. And Walmart was adept at getting suppliers to do things that served the company's long-term interests. Company personnel warmed quickly to the idea of being a far better steward of the environment, and ideas for how Walmart could further the cause of environmental sustainability began to blossom and take root across the company. Walmart's buyers, already responding to growing buyer interest in organic food products, began contracting to buy the products of organic foods producers. In many instances, Walmart made a point of buying organic produce locally, which had the effect of increasing freshness, reducing the shipping costs of food products, and providing local organic farmers with a market for their crops. In February 2006, Walmart announced that over the next three to five years it would purchase all of its wild-caught seafood from fisheries that had been certified as sustainable by the Marine Stewardship Council, an independent nonprofit organization.

After a ladies' apparel buyer for Sam's Club ordered 190,000 units of a yoga outfit made of organic cotton that quickly sold in 10 weeks, Walmart buyers visited organic cotton farms, learned about the environmental benefits of organically grown cotton as opposed to conventionally grown cotton, and began purchasing a range of organic cotton products for Walmart and Sam's Club stores, despite their higher cost.[51] Going into 2007, Walmart was the organic cotton industry's biggest customer, using more than 8 million metric tons; the company made a verbal commitment to buy organic cotton for at least five years, giving organic cotton farmers assurance of a market for their crops.

Walmart began working with suppliers to explore ways to cut packaging costs, promote recycling, and boost energy efficiency. H. Lee Scott spoke personally with the CEO at General Electric about superefficient LED lighting for Walmart stores and a campaign to promote compact fluorescent bulbs, with the CEO of Kimberly-Clark about compressing toilet paper and paper towels into package-saving mega-rolls, with the CEO of PepsiCo about a contest to recycle plastic bottles of Aquafina water and other PepsiCo beverages, and with the CEOs at Procter & Gamble and Unilever about selling concentrated laundry detergent in slimmed-down plastic bottles. In all these instances, Scott indicated that Walmart would put its marketing muscle behind the efforts to win greater consumer acceptance of green products. Scott's efforts had paid off. As of May 2008, all laundry detergent sold at Walmart was concentrated and packaged in smaller containers. Also in 2008, Walmart was selling packs of six Charmin megarolls that contained the same amount of toilet paper as a regular Charmin 24-roll pack—selling twice as many packs of Charmin allowed Walmart to ship twice as many units on its trucks, eliminate 89.5 million cardboard roll cores, eliminate 360,087 pounds of plastic wrapping, and reduce diesel fuel consumption by 53,966 gallons.

In 2007 and 2008, Walmart's environmental sustainability campaign became increasingly sweeping and comprehensive. This was mirrored by a statement on the company's Web site: "Our opportunity is to become a better company by looking at every facet of our business—from the products we offer to the energy we use—through the lens of sustainability."[52] Eighteen environmental sustainability initiatives were launched, including those relating to reduction of greenhouse gases, alternative fuels, protection of wildlife habitat, the use of chemical intensive products, sustainable agriculture and seafood, reusable bags, and eco-friendly textiles and apparel. In November 2007, Walmart issued a comprehensive report detailing its sustainability initiatives and the results being achieved.

Walmart'sF uture

Sam Walton had engineered the development and rapid ascendancy of Walmart to the forefront of the retailing industry—the discount stores and Sam's Clubs were strategic moves that he directed. His handpicked successor, David Glass, had directed the hugely successful move into Supercenters and grocery retailing, as well as presiding over the company's growth into the world's largest retailing enterprise; the Neighborhood Market store format also came into being during his tenure as CEO. H. Lee Scott, Walmart's third CEO, had the challenge of sustaining the company's growth, globalizing Walmart operations, continuing the long-term process of saturating the U.S. market with Supercenters, overseeing Walmart's ever-larger business operations, and, most recently, figuring out how to counteract the efforts of the company's critics and adversaries to portray Walmart as a corporate villain.

In 2008, Scott had reason to believe that his transformation plan was producing the desired results. Company morale was decidedly improved, partly because Walmart's far-reaching efforts to adopt business practices that were better for the environment had energized company personnel, triggered a burst of innovative thinking, and made associates feel good about their jobs and the company. There had been a noticeable falloff in the Walmart bashing that had taken place in 2004–2006. Time would tell whether Scott's transformation initiatives would eventually restore the luster to Walmart's image, spur the company's sales revenues, and reduce community resistance to opening new Supercenters.

But Walmart was beginning to fight back. It had hired a public relations firm, which had put a staff of seven professionals in Bentonville to assist Walmart's own public relations staff to get the company's story out and respond within hours to any new blast of criticism.[53] Since mid-2004, Lee Scott had done nine interviews on TV, met with the editorial boards of *The Wall Street Journal* and the *Washington Post,* been interviewed by numerous newspaper journalists, and spoken to business and community leaders in Chicago, Los Angeles, Istanbul, and Paris. The company was striving to build relationships with congressional delegations, governors, mayors, community leaders, and activists in key locations. It had run ads in more than 100 newspapers. And it created a Web site (www.walmartfacts.com) to help set the record straight about what Walmart did and did not do.

Walmart had received favorable publicity in the media following hurricane Katrina, when its quick response with food, supplies, and cash assistance was praised for being faster than the

U.S. government's effort; Walmart had also donated $15 million to the Katrina relief effort. And there was growing interest on the part of academic researchers over whether Walmart had a positive or negative effect on the economy. A New York University economist reported that a Walmart store opening in Glendale, Arizona, received 8,000 applicants for 525 jobs. A University of Missouri economist in an article published in the prestigious *Review of Economics and Statistics* found that the entry of a Walmart store increased a county's retail employment by 100 jobs in the first year and over time led to the elimination of 50 jobs at less-efficient retailers. Studies also showed that new businesses quickly sprang up near Walmart stores; both new and existing stores along the routes leading to a Walmart tended to flourish because of the heavy traffic flow to and from the company's stores.

But heading into 2009, there continued to be occasional stories in the media that were critical of Walmart's operating practices and of the company in general. It was unclear whether the company's transformation initiatives were having the desired impact on public opinion and whether Walmart's growth and profitability would be adversely affected by its critics and adversaries.

Nonetheless, the economic slowdown that began in early 2008, followed by the global financial crisis and even sharper economic downturn that transpired in Fall 2008, had resulted in significant increases in customer traffic and purchases at Walmart's stores. Many consumers—already feeling the pinch of recessionary forces or else anxious about the prospects of being laid off—were shopping at Walmart more frequently and Walmart's average sales per customer checkout were above prior-year levels, due in part to steep declines in gasoline prices in September–November 2008 which made a trip to Walmart cheaper and gave consumers more discretionary income to spend at Walmart. Sales at Walmart stores open at least a year rose a robust 3.4 percent for the 43-week period ending November 28, 2008 (versus just 1.4 percent for the same period in 2007). Walmart executives believed that in tough economic times Walmart was the best destination for shoppers to save money.

Endnotes

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Case 14

Southwest Airlines in 2008: Culture, Values, and Operating Practices

Arthur A. Thompson
The University of Alabama

John E. Gamble
University of South Alabama

In 2008, more people were flying Southwest Airlines than any other U.S. airline, and Southwest had the enviable distinction of being the only major U.S. air carrier that was consistently profitable. After losing more than $35 billion during 2001–2005, U.S. commercial airlines earned a combined $3.1 billion in 2006 and $5.0 billion in 2007; but sharply higher costs for jet fuel in 2008 were expected to result in another money-losing year for most major U.S. airlines, with the notable exception of Southwest. In August 2008, analysts were projecting combined 2008 losses of $5 to $8 billion for the U.S. airline industry as a whole, depending on what happened to crude oil prices and jet fuel prices for the remainder of the year. However, the U.S. airline industry's profit outlook brightened considerably when crude oil prices dropped below $100 per barrel in September, prompting revised 2008 profit projections for the industry somewhere near break-even point—the difference between buying jet fuel when crude oil was $147 per barrel (as it was in portions of July 2008) versus when crude oil was $100 per barrel (as in a portion of September 2008) equated to a fuel cost savings industrywide of $15 billion.

The U.S. airline industry had lost money in 14 of the 28 years from 1980 through 2007, with combined annual losses exceeding combined annual profits by $15 billion. Yet in July 2008, Southwest reported record quarterly revenues, its 69th consecutive quarter of profitability, rising passenger traffic on its flights, and a record load factor (percentage of available seats sold). The company had reported a profit every year since 1973. During 1990–1994, when the airline industry had five straight money-losing years, laid off 120,000 employees, and lost a cumulative $13 billion, Southwest earned a profit every quarter of every year. It had weathered industry downturns, economywide recessions, fare wars and other attempts by rivals to undercut its business, energy crises, and cataclysmic falloffs in airline traffic due to terrorist attacks. It had contended successfully with a series of industry problems and business pressures—air-traffic congestion, mergers of rivals, stricter government regulations regarding aircraft safety and maintenance, and mounting customer dissatisfaction with airline service.

Once regarded as little more than a scrappy underdog with quirky practices that flew mainly to "secondary" airports (rather than high-traffic airports like Chicago's O'Hare, Dallas–Fort Worth, Atlanta's Hartsfield, and New York's LaGuardia and Kennedy airports), Southwest had proved it was a major competitive force in the U.S. airline industry. It had the lowest operating cost structure in the domestic airline industry and consistently offered the lowest and simplest fares. Not only was it the market share leader in terms of passengers carried, but its market share was climbing at a time when passenger traffic on other major U.S. airlines was stagnant—see Exhibit 1.

Company Background

In late 1966, Rollin King, a San Antonio entrepreneur who owned a small commuter air service, marched into Herb Kelleher's law office with a plan to start a low-cost/low-fare airline that would shuttle passengers between San Antonio, Dallas, and Houston.[1] Over the years, King had heard many Texas businessmen complain about the length of time it took to drive between the three cities and the expense of flying the airlines currently serving these cities. His business concept for the airline was simple: Attract passengers by flying convenient schedules, get passengers to their destination on time, make sure they have a good experience, and charge fares competitive with travel by automobile. Kelleher, skeptical that King's business idea was viable, dug into the possibilities during the next few weeks and concluded a new airline was feasible; he agreed to handle the necessary legal work and also to invest $10,000 of his own funds in the venture.

In 1967, Kelleher filed papers to incorporate the new airline and submitted an application to the Texas Aeronautics Commission for the new company to begin serving Dallas, Houston, and San Antonio.[2] But rival airlines in Texas pulled every string they could to block the new airline from commencing operations, precipitating a contentious four-year parade of legal and regulatory proceedings. Herb Kelleher led the fight on the company's behalf, eventually prevailing in June 1971 after winning two appeals to the Texas Supreme Court and a favorable ruling from U.S. Supreme Court. Kelleher recalled, "The constant proceedings had gradually come to enrage me. There was no merit to our competitors' legal assertions. They were simply trying to use their superior economic power to squeeze us dry so we would collapse before we ever got into business. I was bound and determined to show that Southwest Airlines was going to survive and was going into operation."[3]

In January 1971, Lamar Muse was brought in as the CEO to get operations under way. Muse was an aggressive and self-confident airline veteran who knew the business well and who had the entrepreneurial skills to tackle the challenges of building the airline from scratch and then competing head-on with the major carriers. Through private investors and an initial public offering of stock in June 1971, Muse raised $7 million in new capital to purchase planes and equipment and provide cash for start-up. Boeing agreed to supply three new 737s from its inventory, discounting its price from $5 million to $4 million and financing 90 percent of the $12 million deal.

Because the airline industry was in the throes of a slump in the early 1970s, Muse was able to recruit a talented senior staff that included a number of veteran executives from other carriers. He particularly sought out people who were innovative, wouldn't shirk from doing things differently or unconventionally, and were motivated by the challenge of building an airline from scratch. Muse wanted his executive team to be willing to think like mavericks and not be lulled into instituting practices at Southwest that were largely imitative of those at other airlines. According to Rollin King, "It was our one opportunity to do it right. . . . We all understood that this was our opportunity to decide how to do it our way. Our philosophy was, and still is, we do whatever we have to do to get the job done."[4]

Southwest's Struggle to Gain a Market Foothold

In June 1971, Southwest initiated its first flights with a schedule that soon included six round-trips between Dallas and San Antonio and 12 round-trips between Houston and Dallas. The introductory $20 one-way fares to fly the Golden Triangle, well below the $27 and $28 fares charged by rivals, attracted disappointingly small numbers of passengers—some days the total for all 18 flights would be less than 250 people. Southwest's financial resources were

Exhibit 1

Number of Domestic and International Passengers by Air Carrier, 1998–First Quarter 2008 (in thousands)

CARRIER	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	FIRST QUARTER 2008
America West*											
Domestic	17,305	18,265	19,467	19,013	18,799	19,187	20,151	20,868	19,956	14,674	n.a.
International	475	427	478	565	640	861	982	1,262	1,234	991	n.a.
Total	17,780	18,692	19,945	19,578	19,439	20,048	21,133	22,130	21,190	15,665	n.a.
American Airlines											
Domestic	63,987	63,893	68,319	61,704	77,489	72,202	72,648	77,297	76,813	76,581	17,724
International	17,372	17,516	17,951	16,370	16,580	16,560	18,858	20,710	21,313	21,562	n.a.
Total	81,359	81,409	86,270	78,074	94,069	88,762	91,506	98,007	98,126	98,143	n.a.
Continental Air Lines											
Domestic	34,985	36,130	36,591	34,635	31,653	30,853	31,529	32,971	35,795	37,117	8,713
International	6,611	7,814	8,747	8,058	8,247	7,926	9,146	9,795	10,994	11,859	n.a.
Total	41,596	43,944	45,338	42,693	39,900	38,779	40,675	42,766	46,789	48,976	n.a.
Delta Air Lines											
Domestic	97,879	98,212	97,965	86,888	83,747	77,793	79,374	77,581	63,496	61,599	14,307
International	7,259	7,158	7,596	7,150	7,036	6,335	7,416	8,359	10,020	11,435	n.a.
Total	105,138	105,370	105,561	94,038	90,783	84,128	86,790	85,940	73,516	73,034	n.a.
JetBlue Airways											
Domestic	n.a.	n.a.	1,128	3,056	5,672	8,950	11,616	14,463	18,098	20,528	7,024
International	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	116	218	408	777	n.a.
Total	n.a.	n.a.	1,128	3,056	5,672	8,950	11,732	14,681	18,506	21,305	n.a.
Northwest Airlines											
Domestic	41,931	46,666	48,462	44,786	43,314	43,310	45,959	46,690	45,141	43,812	9,685
International	6,914	7,575	8,228	7,418	7,454	6,871	7,576	7,912	7,831	8,042	n.a.
Total	48,845	54,241	56,690	52,204	50,768	50,181	53,535	54,602	52,972	51,854	n.a.
Southwest Airlines											
Domestic only	59,053	65,288	72,568	73,629	72,459	74,768	81,121	88,436	96,330	101,948	24,724
United Air Lines											
Domestic	75,058	75,436	72,450	63,947	57,830	56,308	60,081	55,173	57,229	56,402	12,369
International	9,912	9,969	10,625	9,996	9,532	8,541	9,490	10,355	10,770	11,011	n.a.
Total	84,970	85,405	83,075	73,943	67,362	64,849	69,571	65,528	67,999	67,413	n.a.
US Airways*											
Domestic	55,603	53,272	56,667	52,658	43,480	37,302	37,810	37,040	31,886	51,895	12,000
International	2,384	2,539	3,105	3,455	3,679	3,954	4,598	4,829	4,609	4,978	n.a.
Total	57,987	55,811	59,772	56,113	47,159	41,256	42,408	41,869	36,495	56,873	n.a.

*US Airways and America West merged in September 2005. US Airways numbers prior to 2007 include only US Airways. America West data are included in US Airways numbers starting in 2007.

n.a. = not applicable.

Source: U.S. Department of Transportation, Bureau of Transportation Statistics, Air Carrier Statistics Form T-100.

stretched so thin that the company bought fuel for several months on Lamar Muse's personal credit card. The company was short of ground equipment, and most of what it had was used and in worn condition. Money for parts and tools was so tight that, on occasion, company personnel got on the phone with acquaintances at rival airlines operating at the terminal and arranged to borrow what was needed. Nonetheless, morale and enthusiasm remained high; company personnel displayed can-do attitudes and adeptness at getting by on whatever resources were available.

To try to gain market visibility and drum up more passengers, Southwest decided it had to do more than just run ads in the media:

- Southwest decided to have its flight hostesses dress in colorful hot pants and white knee-high boots with high heels. Recruiting ads for Southwest's first group of hostesses were headlined "Attention, Raquel Welch: You can have a job if you measure up." Two thousand applicants responded, and those selected for interviews were asked to come dressed in hot pants to show off their legs—the company wanted to hire long-legged beauties with sparkling personalities. More than 30 of Southwest's first graduating class of 40 flight attendants consisted of young women who had been cheerleaders or majorettes in high school and thus had experience performing in front of people while skimpily dressed.
- A second attention-getting action was to give passengers free alcoholic beverages during daytime flights. Most passengers on these flights were business travelers. Management's thinking was that many passengers did not drink during the daytime and that with most flights being less than an hour's duration it would be cheaper to simply give the drinks away rather than collect themo ney.
- Taking a cue from being based at Dallas's Love Field, Southwest began using the tag line "Now There's Somebody Else Up There Who Loves You." The routes between Houston, Dallas, and San Antonio became known as the Love Triangle. Southwest's planes were referred to as Love Birds, drinks became Love Potions, peanuts were called Love Bites, drink coupons were Love Stamps, and tickets were printed on Love Machines. The "Love" campaign set the tone for Southwest's approach to its customers and company efforts to make flying Southwest an enjoyable, fun, and differentiating experience. (Later, when the company went public, it chose LUV as its stock-tradings ymbol.)
- In order to add more flights without buying more planes, the head of Southwest's ground operations came up with a plan for ground crews to off-load passengers and baggage, refuel the plane, clean the cabin and restock the galley, on-load passengers and baggage, do the necessary preflight checks and paperwork, and push away from the gate in 10 minutes. The 10-minute turn became one of Southwest's signatures during the 1970s and 1980s. (In later years, as passenger volume grew and many flights were filled to capacity, the turnaround time gradually expanded to 25 minutes—because it took more time to unload and load a full plane with 125 passengers, as compared to a half-full plane with just 60–65 passengers. Even so, the 25-minute average turnaround time at Southwest in 2002 was still shorter than the 40- to 60-minute turnaround times typical at other major airlines.)
- In late November 1971, Lamar Muse came up with the idea of offering a $10 fare to passengers on the Friday-night Houston–Dallas flight. With no advertising, the 112-seat flight sold out. This led Muse to realize that Southwest was serving two quite distinct types of travelers in the Golden Triangle market: (1) business travelers who were more time-sensitive than price-sensitive and wanted weekday flights at times

suitable for conducting business and (2) price-sensitive leisure travelers who wanted lower fares and had more flexibility about when to fly.[5] He came up with a two-tier on-peak and off-peak pricing structure in which all seats on weekday flights departing before 7:00 p.m. were priced at $26 and all seats on other flights were priced at $13. Passenger traffic increased significantly—and systemwide on-peak and off-peak pricing soon became standard across the whole airline industry.

- In 1972, the company decided to move its flights in Houston from the newly opened Houston Intercontinental Airport (where it was losing money and where it took 45 minutes to get to downtown) to the abandoned Houston Hobby Airport located much closer to downtown Houston. Despite being the only carrier to fly into Houston Hobby, the results were spectacular—business travelers that flew to Houston frequently from Dallas and San Antonio found the Houston Hobby location far more convenient, and passenger traffic doubled almost immediately.
- In early 1973, in an attempt to fill empty seats on its San Antonio–Dallas flights, Southwest cut its regular $26 fare to $13 for all seats, all days, and all times. When Braniff International, at that time one of Southwest's major rivals, announced $13 fares of its own, Southwest retaliated with a two-page ad, run in the Dallas newspapers, headlined "Nobody Is Going to Shoot Southwest Airlines Out of the Sky for a Lousy $13" and containing copy saying Braniff was trying to run Southwest out of business. The ad announced that Southwest would not only match Braniff's $13 fare but that it would also give passengers the choice of buying a regular-priced ticket for $26 and receiving a complimentary fifth of Chivas Regal scotch, Crown Royal Canadian whiskey, or Smirnoff vodka (or, for nondrinkers, a leather ice bucket). Over 75 percent of Southwest's Dallas–Houston passengers opted for the $26 fare, although the percentage dropped as the two-month promotion wore on and corporate controllers began insisting that company employees use the $13 fare. The local and national media picked up the story of Southwest's offer, proclaiming the battle as a David-versus-Goliath struggle in which the upstart Southwest did not stand much of a chance against the much larger and well-established Braniff; grassroots sentiment in Texas swung to Southwest's side.

Southwest reported its first-ever annual profit in 1973.

More Legal and Regulatory Hurdles

During the rest of the 1970s, Southwest found itself embroiled in another round of legal and regulatory battles. One involved Southwest's refusal to move its flights from Dallas Love Field, located 10 minutes from downtown, out to the newly opened Dallas–Fort Worth Regional Airport, which was 30 minutes from downtown Dallas. Local officials were furious because they were counting on fees from Southwest's flights in and out of DFW to help service the debt on the bonds issued to finance the construction of DFW. Southwest's position was that it was not required to move because it had not agreed to do so nor had it been ordered to do so by the Texas Aeronautics Commission—moreover, the company's headquarters were located at Love Field. The courts eventually ruled that Southwest's operations could remain at Love Field.

A second battle ensued when rival airlines protested Southwest's application to begin serving several smaller cities in Texas; their protest was based on arguments that these markets were already well served and that Southwest's entry would result in costly overcapacity. Southwest countered that its low fares would allow more people to fly and grow the market. Again, Southwest prevailed and its views about low fares expanding the market proved accurate.

In the year before Southwest initiated service, 123,000 passengers flew from Harlingen Airport in the Rio Grande Valley to Houston, Dallas, or San Antonio; in the 11 months following Southwest's initial flights, 325,000 passengers flew to the same three cities.

Believing that Braniff and Texas International were deliberately engaging in tactics to harass Southwest's operations, Southwest convinced the U.S. government to investigate what it considered predatory tactics by its chief rivals. In February 1975, Braniff and Texas International were indicted by a federal grand jury for conspiring to put Southwest out of business—a violation of the Sherman Antitrust Act. The two airlines pleaded "no contest" to the charges, signed cease-and-desist agreements, and were fined a modest $100,000 each.

When Congress passed the Airline Deregulation Act in 1978, Southwest applied to the Civil Aeronautics Board (now the Federal Aviation Agency) to fly between Houston and New Orleans. The application was vehemently opposed by local government officials and airlines operating out of Dallas–Fort Worth (DFW) because of the potential for passenger traffic to be siphoned away from DFW. The opponents solicited the aid of Fort Worth congressman Jim Wright, the majority leader of the U.S. House of Representatives, who took the matter to the floor of the House of Representatives; a rash of lobbying and maneuvering ensued. What emerged came to be known as the Wright Amendment of 1979: No airline could provide nonstop or through-plane service from Dallas Love Field to any city in any state except for locations in states bordering Texas. The amendment, which continued in effect as of 2003, meant that Southwest could not advertise, publish schedules or fares, or check baggage for travel from Dallas's Love Field to any city it served outside Texas, Louisiana, Arkansas, Oklahoma, and New Mexico.

The Battles to Survive Breed a Warrior Mentality

The legal, regulatory, and competitive battles that Southwest fought in its early years produced a strong esprit de corps among Southwest personnel and a drive to survive and prosper despite the odds. With newspaper and TV stories reporting Southwest's difficulties regularly, employees were fully aware that the airline's existence was constantly on the line. Had the company been forced to move from Love Field, it would most likely have gone under, an outcome that employees, Southwest's rivals, and local government officials understood well. According to Southwest's president, Colleen Barrett, the obstacles thrown in Southwest's path by competitors and local officials were instrumental in building Herb Kelleher's passion for Southwest Airlines and ingraining a combative, can-do spirit into the corporate culture:

> They would put twelve to fifteen lawyers on a case and on our side there was Herb. They almost wore him to the ground. But the more arrogant they were, the more determined Herb got that this airline was going to go into the air—and stay there.
>
> The warrior mentality, the very fight to survive, is truly what created our culture.[6]

The Start of the Herb Kelleher Era

When Lamar Muse resigned in 1978, Southwest's board wanted Herb Kelleher to take over as chairman and CEO. But Kelleher enjoyed practicing law and, while he agreed to become chairman of the board, he insisted that someone else be CEO. Southwest's board appointed Howard Putnam, a group vice president of marketing services at United Airlines, as Southwest's president and CEO in July 1978. Putnam asked Kelleher to become more involved in Southwest's day-to-day operations, and over the next three years, Kelleher got to know many of the company's personnel and observe them in action. Putnam announced his resignation in the fall of 1981 to become president and chief operating officer at Braniff International. This time, Southwest's board succeeded in persuading Kelleher to take on the additional duties of CEO and president.

When Kelleher took over in 1981, Southwest had 27 planes, $270 million in revenues, 2,100 employees, and 14 destination cities. Over the

Exhibit 2

Milestones at Southwest Airlines, 1983–2007

1983	Three additional Boeing 737s are purchased; Southwest flies more than 9.5 million passengers.
1984	Southwest is ranked first in customer satisfaction among the U.S. airlines for the fourth straight year.
1985	Service begins to St. Louis and Chicago Midway airports. Southwest names the Ronald McDonald House as its primary charity—the tie-in was the result of an effort by a Southwest pilot who lost a daughter to leukemia and who believed that Ronald McDonald Houses were a worthy way to demonstrate Southwest's community spirit.
1986	Southwest flies more than 13 million passengers.
1988	Southwest becomes the first U.S. airline to win the Triple Crown (best on-time record, fewest reports of mishandled baggage, and fewest complaints per 100,000 passengers) for a single month.
1990	Revenues reach $1 billion; Southwest was the only major U.S. airline to record both an operating profit and a net profit.
1992	Southwest wins its first annual Triple Crown for best on-time record, best baggage handling, and fewest customer complaints; for the second year running, Southwest was the only major U.S. airline to record both an operating profit and a net profit.
1993	Southwest begins operations on the East Coast and wins its second annual Triple Crown; revenues exceed $2 billion and profits exceed $100 million. For the third consecutive year, Southwest is the only major U.S. airline to record both an operating profit and a net profit.
1994	Southwest leads the industry by introducing ticketless travel in four cities; Southwest wins its third Triple Crown and acquires Morris Air, based in Salt Lake City.
1995	Ticketless travel becomes available systemwide; Southwest wins fourth consecutive Triple Crown.
1996	Service to Florida begins; Southwest wins fifth consecutive Triple Crown. Southwest and its employees contribute almost $740,000 to help support Ronald McDonald Houses, including $34,000 in cash donations from the company and $302,500 in free air travel for families staying at Ronald McDonald Houses in cities served by Southwest.
1997	Service begins to Southwest's 50th city; more than 50 million people fly Southwest.
1998	Southwest is named by *Fortune* as the best company to work for in America.
1999	Service is added to three more cities.
2000	The number of passengers on Southwest flights exceeds 60 million, and revenues surpass the $5 billion mark; the company records its 28th consecutive year of profitability and ninth consecutive year of increased profits. Southwest becomes the fourth largest U.S. airline in terms of passengers carried.
2001	Southwest is profitable for the 30th consecutive year and the only U.S. airline to report a profit for 2001; a record 64.5 million passengers fly Southwest.
2002	Southwest ranks second among companies across all industry groups, and first in the airline industry on *Fortune*'s 2002 list of America's most admired companies.
2005	Southwest becomes the second largest U.S. airline in terms of passengers carried.
2006	A record 96.3 million passengers fly Southwest.
2007	Southwest becomes the largest U.S. airline in terms of passengers carried and is profitable for the 35th consecutive year. Southwest Airlines is named to *BusinessWeek*'s first ever "Customer Service Champs" list and is voted "Overall Best Airline" in the United States by Frost & Sullivan's CEO Leadership Forum.

next 26 years, Southwest Airlines prospered, racking up many industry firsts and expanding into more geographic areas—see Exhibit 2. In 2008, Southwest was the largest U.S. commercial airline in terms of passengers flown and the sixth largest in terms of revenues. It had 2007 revenues of $9.9 billion annually and 34,000 employees, and its 527 jets flew 3,400 flights to 64 cities in 32 states. Southwest had been profitable every year since 1973—in an industry noted for its vulnerability to economic cycles and feast-or-famine profitability. During 1990–1994,

Exhibit 3

Summary of Southwest Airlines' Financial and Operating Performance, 2003–2007

	YEARS ENDED DECEMBER 31				
	2007	**2006**	**2005**	**2004**	**2003**
Financial Data (in millions, except per share data)					
Operating revenues	$ 9,861	$ 9,086	$ 7,584	$ 6,530	$5,937
Operating expenses	9,070	8,152	6,859	6,126	5,558
Operating income	791	934	725	404	379
Other expenses (income) net	(267)	144	(54)	65	(225)
Income before taxes	1,058	790	779	339	604
Provision for income taxes	413	291	295	124	232
Net Income	$ 645	$ 499	$ 484	$ 215	$ 372
Net income per share, basic	$ 0.85	$ 0.63	$ 0.61	$ 0.27	$ 0.48
Net income per share, diluted	.84	.61	.60	.27	.46
Cash dividends per common share	$ 0.018	$ 0.018	$ 0.018	$ 0.018	$0.018
Total assets at period-end	$16,772	$13,460	$14,003	$11,137	$9,693
Long-term obligations at period-end	$ 2,050	$ 1,567	$ 1,394	$ 1,700	$1,332
Stockholders' equity at period-end	$ 6,941	$ 6,449	$ 6,675	$ 5,527	$5,029
Operating Data					
Revenue passengers carried	88,713,472	83,814,823	77,693,875	70,902,773	65,673,945
Enplaned passengers	101,910,809	96,276,907	88,379,900	81,066,038	74,719,340
Revenue passenger miles (RPMs) (000s)	72,318,812	67,691,289	60,223,100	53,418,353	47,943,066
Available seat miles (ASMs) (000s)	99,635,967	92,663,023	85,172,795	76,861,296	71,790,425
Load factor*	72.6	73.1	70.7	69.5	66.8
Average length of passenger haul (miles)	815	808	775	753	730
Average aircraft stage length (miles)	629	622	607	576	558
Trips flown	1,160,699	1,092,331	1,028,639	981,591	949,882
Average passenger fare	$106.60	$104.40	$ 93.68	$ 88.57	$87.42
Passenger revenue yield per RPM	13.08¢	12.93¢	12.09¢	11.76¢	11.97¢
Operating revenue yield per ASM	9.90¢	9.81¢	8.90¢	8.50¢	8.27¢
Operating expenses per ASM	9.10¢	8.80¢	8.05¢	7.97¢	7.74¢
Fuel costs per gallon (average)	$ 1.70	$ 1.53	$ 1.03	$ 0.83	$ 0.72
Fuel consumed, in gallons (millions)	1,489	1,389	1,287	1,201	1,143
Full-time equivalent employees at year-end	34,378	32,664	31,729	31,011	32,847
Size of fleet at year-end†	520	481	445	417	388

*Revenue passenger miles divided by available seat miles.

†Includes leased aircraft.

Source: 2007 10-K report.

when the airline industry had five straight money-losing years, laid off 120,000 employees, and lost a cumulative $13 billion, Southwest earned a profit every quarter of every year.

Exhibit 3 provides a five-year summary of Southwest's financial and operating performance. Exhibits 4 and 5 provide industrywide data on airline travel for 1995–2008.

Herb Kelleher: Cofounder of Southwest and Longtime CEO

Herb Kelleher majored in philosophy at Wesleyan University in Middletown, Connecticut, graduating with honors. He earned his law degree at New York University, again graduating with honors and also serving as a member

Exhibit 4

Selected Operating and Financial Data for Major U.S. Airline Carriers, Selected Years 1995–First Quarter 2008

	1995	2000	2005	2006	2007	FIRST QUARTER 2008
Passengers (in millions)	559.0	666.2	738.3	744.2	769.2	181.1
Flights (in thousands)	8,062.0	9,035.0	11,558.0	11,264.0	11,365.0	2,529.7
Revenue passenger miles (in billions)	603.4	692.8	778.6	796.8	829.0	190.3
Available seat miles (in billions)	807.1	987.9	1,016.4	1,006.3	1,037.6	247.7
Load factor	67.0	72.3	77.5	79.2	79.9	77.2
Passenger revenues (in millions)	$69,470	$93,622	$93,500	$101,419	$107,011	$25,527
Average domestic fare (4th quarter)	$ 288	$ 340	$ 315	$ 318	$ 331	n.a.
Operating profit (loss) (in millions)	$ 5,852	$ 6,999	$ 427	$ 7,514	$ 9,210	n.a.
Net profit (loss) (in millions)	$ 2,283	$ 2,486	($ 5,782)	$ 3,126	$ 4,998	n.a.
Fuel cost (in millions)	$ 9,696	$16,447	$33,150	$ 38,548	$ 41,580	$12,824
Total employees	546,987	679,967	562,467	545,695	560,997	n.a.

Sources: Air Transport Association, *2008 Economic Report,* p. 7; Air Transport Association, *2005 Economic Report,* p. 7; and U.S. Department of Transportation, Bureau of Transportation Statistics, airline traffic data press releases, various years.

Exhibit 5

Operating Revenues of Selected U.S. Airlines, 2000–2007 (in billions)

AIRLINE	2007	2006	2005	2004	2003	2002	2001	2000
American	$22.9	$22.5	$20.6	$18.6	$17.4	$15.9	$15.6	$18.1
United	20.1	19.3	17.3	15.7	13.4	13.9	16.1	19.3
Delta	19.2	17.5	16.5	15.2	14.3	12.4	13.2	15.3
Continental	14.2	13.1	11.1	9.9	7.3	7.4	8.2	9.4
Northwest	12.5	12.6	12.3	11.3	10.1	9.2	9.6	11.0
US Airways	11.7	11.6	7.2	7.1	6.8	6.9	8.3	9.2
Southwest	9.9	9.1	7.6	6.5	5.9	5.5	5.6	5.7
America West	*	*	3.4	2.5	2.2	2.0	2.0	2.3

*Merged with US Airways in 2005; revenues included in US Airways for 2006 and 2007.
Sources: Bureau of Transportation Statistics, *Air Carrier Financial Reports,* Schedule P-12, and company annual reports for 2007.

of the law review. After graduation, he clerked for a New Jersey Supreme Court justice for two years and then joined a law firm in Newark. Upon marrying a woman from Texas and becoming enamored with Texas, he moved to San Antonio, where he became a successful lawyer and came to represent Rollin King's small aviation company.

When Kelleher took on the role of Southwest's CEO in 1981, he made a point of visiting with maintenance personnel to check on how well the planes were running and talking with the flight attendants. Kelleher did not do much managing from his office, preferring instead to be out among the troops as much as he could. His style was to listen and observe and to offer encouragement. Kelleher attended most graduation ceremonies of flight attendant classes, and he often appeared to help load bags on Black Wednesday, the busy travel day before Thanksgiving. He knew the names of thousands of Southwest employees and was held in the highest regard by Southwest employees. When he attended a Southwest employee function, he was swarmed like a celebrity.

Kelleher had an affinity for bold-print Hawaiian shirts, owned a tricked-out motorcycle, and made no secret of his love for smoking cigarettes and drinking Wild Turkey whiskey. He loved to make jokes and engage in pranks and corporate antics, prompting some people to refer to him as the "clown prince" of the airline industry. He once appeared at a company gathering dressed in an Elvis costume and had arm-wrestled a South Carolina company executive at a public event in Dallas for rights to use "Just Plane Smart" as an advertising slogan.[7] Kelleher was well-known inside and outside the company for his combativeness, particularly when it came to beating back competitors. On one occasion, he reportedly told a group of veteran employees, "If someone says they're going to smack us in the face—knock them out, stomp them out, boot them in the ditch, cover them over, and move on to the next thing. That's the Southwest spirit at work."[8] On another occasion, he said, "I love battles. I think it's part of the Irish in me. It's like what Patton said, 'War is hell and I love it so.' That's how I feel. I've never gotten tired of fighting."[9]

While Southwest was deliberately combative and flamboyant in some aspects of its operations, when it came to the financial side of the business Kelleher insisted on fiscal conservatism, a strong balance sheet, comparatively low levels of debt, and zealous attention to bottom-line profitability. While believing strongly in being prepared for adversity, Kelleher had an aversion to Southwest personnel spending time drawing up all kinds of formal strategic plans; he once said, "Reality is chaotic; planning is ordered and logical. The meticulous nit-picking that goes on in most strategic planning processes creates a mental straitjacket that becomes disabling in an industry where things change radically from one day to the next." Kelleher wanted Southwest managers to think ahead, have contingency plans, and be ready to act when it appeared that the future held significant risks or when new conditions suddenly appeared and demanded prompt responses.

Kelleher was a strong believer in the principle that employees—not customers—came first:

> You have to treat your employees like your customers. When you treat them right, then they will treat your outside customers right. That has been a very powerful competitive weapon for us. You've got to take the time to listen to people's ideas. If you just tell somebody no, that's an act of power and, in my opinion, an abuse of power. You don't want to constrain people in their thinking.[10]

Another indication of the importance that Kelleher placed on employees was the message he had penned in 1990 that was prominently displayed in the lobby of Southwest's headquarters in Dallas:

> The people of Southwest Airlines are "the creators" of what we have become—and of what we will be.
>
> Our people transformed an idea into a legend. That legend will continue to grow only so long as it is nourished—by our people's indomitable spirit, boundless energy, immense goodwill, and burning desire to excel.
>
> Our thanks—and our love—to the people of Southwest Airlines for creating a marvelous family and a wondrous airline.

In June 2001, Herb Kelleher stepped down as CEO but continued on in his role as chairman of Southwest's board of directors and the head of the board's executive committee; as chairman, he played a lead role in Southwest's strategy, expansion to new cities and aircraft scheduling, and governmental and industry affairs. In May 2008, after more than 40 years of leadership at Southwest, Kelleher retired as chairman of the board (but he was scheduled to remain a full-time Southwest employee until July 2013).

New Executive Leadership at Southwest: 2001–2008

In June 2001, Southwest Airlines, responding to anxious investor concerns about the company's leadership succession plans, began an orderly transfer of power and responsibilities from Herb Kelleher, age 70, to two of his most trusted protégés. James F. Parker, 54, Southwest's general counsel and one of Kelleher's most trusted protégés, succeeded Kelleher as Southwest's CEO. Another of Kelleher's trusted protégés, Colleen Barrett, 56, Southwest's executive vice president–customers and self-described keeper of Southwest's pep rally corporate culture, became president and chief operating officer.

James Parker: CEO, 2001–2004

James Parker's association with Herb Kelleher went back 23 years, to the time when they were colleagues at Kelleher's old law firm. Parker moved over to Southwest from the law firm in February 1986. Parker's profile inside the company as Southwest's vice president and general counsel had been relatively low, but he was Southwest's chief labor negotiator and much of the credit for Southwest's good relations with employee unions belonged to Parker. Prior to his appointment as CEO, Parker had been a member of the company's executive planning committee; his experiences ranged from properties and facilities to technical services to the company's alliances with vendors and partners. Parker and Kelleher were said to think much alike, and Parker was regarded as having a good sense of humor, although he did not have as colorful and flamboyant a personality as Kelleher. Parker was seen as an honest, straight-arrow kind of person who had a strong grasp of Southwest's culture and market niche and who could be nice or tough, depending on the situation. When his appointment was announced, Parker said:

> There is going to be no change of course insofar as Southwest is concerned. We have a very experienced leadership team. We've all worked together for a long time. There will be evolutionary changes in Southwest, just as there have always been in our history. We're going to stay true to our business model of being a low-cost, low-fare airline.[11]

Parker retired unexpectedly, for personal reasons, in July 2004, stepping down as CEO and vice chairman of the board and also resigning from the company's board of directors. He was succeeded by Gary C. Kelly.

Colleen Barrett: Southwest's President, 2001–2008

Colleen Barrett began working as Herb Kelleher's legal secretary in 1967 and had been with Southwest since 1978. As executive vice president–customers, Barrett had a high profile among Southwest employees and spent most of her time on culture building, morale building, and customer service; her goal was to ensure that employees felt good about what they were doing and felt empowered to serve the cause of Southwest Airlines.[12] She and Kelleher were regarded as Southwest's guiding lights, and some analysts said she was essentially functioning as the company's chief operating officer prior to her formal appointment as president. Much of the credit for the company's strong record of customer service and its strong-culture work climate belonged to Barrett.

Barrett had been the driving force behind lining the hallways at Southwest's headquarters with photos of company events and trying to create a family atmosphere at the company. Believing it was important to make employees feel cared about and important, Barrett had put together a network of contacts across the company to help her stay in touch with what was happening with employees and their families. When network members learned about events that were worthy of acknowledgment, the word quickly got to Barrett—the information went into a database and an appropriate greeting card or gift was sent. Barrett had a remarkable ability to give gifts that were individualized and connected her to the recipient.[13]

Barrett was the first woman appointed as president and chief operating officer of a major U.S. airline. In October 2001, *Fortune* included Barrett on its list of the 50 most powerful women in American business (she was ranked number 20). Barrett retired as Southwest's president in July 2008 but was scheduled to remain as a full-time Southwest employee until 2013.

Gary C. Kelly: Southwest's CEO, 2004–Present

Gary Kelly was appointed vice chairman of the board of directors and CEO of Southwest effective July 15, 2004. Prior to that time, Kelly was executive vice president and chief financial officer from 2001 to 2004, and vice president–finance and chief financial officer from 1989 to 2001. He joined Southwest in 1986 as its controller. In 2008, effective with the retirement of Kelleher and Barrett, Kelly assumed the titles of chairman of the board, CEO, and president.

When he was named CEO in 2004, Herb Kelleher said:

> Gary Kelly is one of our brightest stars, well respected throughout the industry and well known, over more than a decade, to the media, analyst, and investor communities for his excellence. As part of our Board's succession planning, we had already focused on Gary as Jim Parker's successor, and that process has simply been accelerated by Jim's personal decision to retire. Under Gary's leadership, Southwest has achieved the strongest balance sheet in the American airline industry; the best fuel hedging position in our industry; and tremendous progress in technology.[14]

During his tenure as CEO, Kelly had worked with other top-level Southwest executives to sharpen and fine-tune Southwest's strategy in a number of areas, continued to expand operations (adding both more flights and initiating service to new airports), and strived to maintain the company's low-cost advantage over its domestic rivals.

Kelly saw four factors as keys to Southwest's recipe for success:

- Hire great people; treat 'em like family.
- Care for our Customers warmly and personally, like they're guests in our home.
- Keep fares and operating costs lower than anybody else by being safe, efficient, and operationallye xcellent.
- Stay prepared for bad times with a strong balance sheet, lots of cash, and a stout fuel hedge.[15]

To help Southwest be a standout performer on these four key success factors, Kelly had established five strategic objectives:

- Be the best place to work.
- Be the safest, most efficient, and most reliable airline in the world.
- Offer Customers a convenient flight schedule with lots of flights to lots of places they want to go.
- Offer Customers the best overall travel experience.
- Do all of these things in a way that maintains a low cost structure and the ability to offer low fares.[16]

Southwest Airlines' Strategy

From day one, Southwest had pursued a low-cost/low-price/no-frills strategy. Its signature low fares made air travel affordable to a wide segment of the U.S. population—giving substance to the company's tag line "The Freedom to Fly." It employed a relatively simple fare structure featuring low, unrestricted, unlimited, everyday coach fares, as well as even lower fares available on a restricted basis. All of Southwest's different fare options could easily be perused at the company's Web site, and the company's restrictions on tickets were more lenient than those of its rivals. In 2008, its highest one-way unrestricted walkup fare was $399 (a fare charged for its longest flights); substantially lower fares were available for short- and medium-distance flights. Many flights had some seats available at deeply discounted fares, provided they were purchased via the company's Web site. In November 2007, Southwest introduced a new Business Select fare to attract economy-minded business travelers; Business Select customers had early boarding privileges, received extra Rapid Rewards (frequent-flyer credits), and a free cocktail. In 2008, when rival airlines instituted a series of add-on fees—including a fuel surcharge for each flight, fees for checking bags, fees for processing frequent-flyer travel awards, fees for buying a ticket in person at the airport, and fees for in-flight beverages—in order to cover skyrocketing costs for jet fuel (which had climbed from about 15 percent of operating expenses in 2000 to 40 percent of operating expenses in mid-2008), Southwest chose to forgo à la carte pricing and stuck with an all-inclusive fare price.

From time to time, Southwest ran special fare promotions. To celebrate its 30th anniversary in 2001, Southwest announced special $30 one-way fares to 30 destinations from 35 cities for a four-month travel period; its car rental and hotel partners participated in the promotion, offering $30-per-day rentals, $30-off discounts, and $30-per-day hotel rooms at some locations. The 30-year celebration also included decorations in gate areas, prize giveaways, and employees playing games in the gate areas so that customers could share in the "Southwest Spirit."

Southwest was a shrewd practitioner of the concept of price elasticity, proving in one market after another that the revenue gains from increased ticket sales and the volume of passenger traffic would more than compensate for the revenue erosion associated with low fares. When Southwest entered the Florida market with an introductory $17 fare from Tampa to Fort Lauderdale, the number of annual passengers flying the Tampa–Fort Lauderdale route jumped 50 percent, to more than 330,000. In Manchester, New Hampshire, passenger counts went from 1.1 million in 1997, the year prior to Southwest's entry, to 3.5 million in 2000 and average one-way fares dropped from just over $300 to $129. Southwest's success in stimulating higher passenger traffic at airports across the United States via low fares and frequent flights had been dubbed the "Southwest effect" by personnel at the U.S. Department of Transportation. Exhibit 6 shows the cities

Exhibit 6

Airports and Cities Served by Southwest Airlines, May 2008

SOUTHWEST'S TOP 10 AIRPORTS	DAILY DEPARTURES	NUMBER OF GATES	NONSTOP CITIES SERVED
Las Vegas	240	21	55
Chicago Midway	225	29	47
Phoenix	198	24	43
Baltimore/Washington	166	26	38
Oakland	134	13	21
Houston Hobby	145	17	29
Dallas (Love Field)	140	14	16
Los Angeles	127	11	19
Orlando	112	14	37
San Diego	108	10	19

OTHER AIRPORTS SERVED BY SOUTHWEST AIRLINES

Albany	El Paso	Manchester, NH	Reno/Tahoe
Albuquerque	Fort Lauderdale	Midland/Odessa	Sacramento
Amarillo	Fort Myers/Naples	New Orleans	St. Louis
Austin	Harlingen/South Padre Island	Norfolk	Salt Lake City
Birmingham	Hartford/Springfield	Oklahoma City	San Antonio
Boise	Indianapolis	Omaha	San Jose
Buffalo	Long Island/Islip	Ontario, CA	Seattle
Burbank	Jackson, MS	Orange County, CA	Spokane
Cleveland	Jacksonville	Philadelphia	Tampa
Columbus, OH	Kansas City	Pittsburgh	Tucson
Corpus Christi	Little Rock	Portland OR	Tulsa
Denver	Louisville	Providence	Washington, DC (Dulles)
Detroit Metro	Lubbock	Raleigh-Durham	West Palm Beach

Source: Southwest Airlines.

and airports Southwest served in mid-2008; Southwest had sizable market shares at the five airports where its passenger counts were highest: Oakland (65 percent), Baltimore (55 percent), Las Vegas (38 percent), Phoenix (31 percent), and Chicago Midway (18 percent).

Unlike the hub-and-spoke route systems of rival airlines (where operations were concentrated at a limited number of hub cities and most destinations were served via connections through the hub), Southwest's route system had been carefully designed to concentrate on flights between pairs of cities 150 to 700 miles apart where there was enough passenger traffic that Southwest could offer a sizable number of daily flights. As a general rule, Southwest did not initiate service to an airport unless it envisioned the potential for originating at least eight flights a day there and saw opportunities to add more flights over time—in Denver, for example, Southwest had boosted the number of daily departures from 13 in January 2006 (the month in which service to and from Denver was initiated) to 79 in May 2008. Southwest's point-to-point route system minimized connections, delays, and total trip time—its emphasis on nonstop flights between about 410 pairs of cities in 2008 allowed about 75 percent of Southwest's passengers to fly nonstop to their destination. While a majority of Southwest's flights involved actual in-air flight times of less than 90 minutes, in recent years the company had added a significant number of nonstop flights to more distant destinations at those airports where its classic low fares could generate profitable amounts of passenger traffic.

Southwest's frequent-flyer program, Rapid Rewards, was based on trips flown rather than mileage. Rapid Rewards customers received one credit for each one-way trip or two credits for each round-trip flown and could also earn credits by using the services of Southwest's car rental, hotel, and credit card partners. There were two types of travel awards: (1) one free round-trip after the accumulation of 16 credits within 24 months and (2) a companion pass for travelers who accumulated 100 credits within a 12-month period—the companion pass was for unlimited free round-trip travel, provided the Rapid Rewards member purchased a ticket or used a free award ticket and the companion Rapid Rewards member flew on the same flight. Award tickets were automatically generated when earned, valid for 12 months after issuance, and subject to a limited number of blackout dates around major holidays. Rapid Rewards members who flew 32 qualifying flights within a 12-month period received priority boarding privileges for a year. In 2007, Southwest customers redeemed approximately 2.8 million award tickets and flights on companion passes, accounting for about 6.2 percent of the passengers on Southwest flights.

Customer Service and Customer Satisfaction

Southwest's approach to delivering good customer service and creating customer satisfaction was predicated on presenting a happy face to passengers, displaying a fun-loving attitude, and doing things in a manner calculated to make sure passengers had a positive flying experience. The company made a special effort to employ gate personnel who enjoyed interacting with customers, had good interpersonal skills, and displayed cheery, outgoing personalities. A number of Southwest's gate personnel let their wit and sense of humor show by sometimes entertaining those in the gate area with trivia questions or contests such as "Who has the biggest hole in their sock?" Apart from greeting passengers coming onto planes and assisting them in finding open seats and stowing baggage, flight attendants were encouraged to be engaging, converse and joke with passengers, and go about their tasks in ways that made passengers smile. On some flights, attendants sang announcements to passengers on takeoff and landing. On one flight while passengers were boarding, an attendant with bunny ears popped out of an overhead bin exclaiming "Surprise!" The repertoires used to amuse passengers varied from flight crew to flight crew.

Both Herb Kelleher and Colleen Barrett had made a point of sending congratulatory notes to employees when the company received letters from customers complimenting particular Southwest employees; complaint letters were seen as learning opportunities for employees and reasons to consider making adjustments. Barrett provided the following policy guidelines to employees regarding how far to go in trying to please customers:

> No Employee will ever be punished for using good judgment and good old common sense when trying to accommodate a Customer—no matter what our rules are.[17]
>
> When you empower People to make a positive difference every day, you allow them to decide. Most guidelines are written to be broken as long as the Employee is leaning toward the Customer. We follow the Golden Rule and try to do the right thing and think about our Customer.[18]

Southwest executives believed that conveying a friendly, fun-loving spirit to customers was the key to competitive advantage. As one Southwest manager put it, "Our fares can be matched; our airplanes and routes can be copied. But we pride ourselves on our customer service."[19] The company's mission statement, revised in 2008, highlighted its customer service commitment:

> The mission of Southwest Airlines is dedication to the highest quality of Customer Service delivered with a sense of warmth, friendliness, individual pride, and CompanyS pirit.

In 2007, Southwest did an "extreme gate makeover" to improve the airport experience of customers. The makeover included adding (1) a business-focused area with padded seats, tables with power outlets, power stations with stools, and a flat-screen TV with news programming and (2) a family-focused area with smaller tables and chairs, power stations for charging electrical devices, and kid-friendly programming on a flat screen TV.

Marketingan dP romotion

Southwest was continually on the lookout for novel ways to tell its story, make its distinctive persona come alive, and strike a chord in the minds of air travelers. Many of its print ads and billboards were deliberately unconventional and attention-getting so as to create and reinforce the company's maverick, fun-loving, and combative image. Some previous campaigns had included such tag lines as "*The* Low-Fare Airline" and "The All-Time On-Time Airline"; others touted the company's Triple Crown awards. One of the company's billboard campaigns promoted the frequency of the company's flights with such phrases as "Austin Auften," "Phoenix Phrequently," and "L.A. A.S.A.P." Each holiday season since 1985 Southwest had run a "Christmas card" ad on TV featuring children and their families from the Ronald McDonald Houses and Southwest employees. Fresh advertising campaigns were launched periodically— Exhibit 7 shows four representative ads.

In 2002, Southwest began changing the look of its planes, updating its somewhat drab gold/orange/red scheme to a much fresher and brighter canyon blue/red/gold/orange scheme—see Exhibit8 .

OtherS trategyE lements

Southwest's strategy included several other elements:

- *Gradual expansion into new geographic markets*—Southwest generally added one or two new cities to its route schedule annually, preferring to saturate the market for daily flights to the cities/airports it currently served before entering new markets. In selecting new cities, Southwest looked for city pairs that could generate substantial amounts of both business and leisure traffic. Management believed that having numerous flights flying the same routes appealed to business travelers looking for convenient flight times and the ability to catch another flight if they unexpectedly ranl ate.
- *Adding flights in areas where rivals were cutting back service*—When rivals cut back flights to cities that Southwest served, Southwest often moved in with more flights of its own, believing its lower fares would attract more passengers. When

EXHIBIT 7 **Four Samples of Southwest's Ads**

EXHIBIT 8 **Southwest's New Look and Aircraft Equipped with Winglets**

Old Color Scheme
(plane without winglets)

New Color Scheme
(plane with winglets)

Midway Airlines ceased operations in November 1990, Southwest moved in overnight and quickly instituted flights to Chicago's Midway Airport. Southwest was a first-mover in adding flights on routes where rivals had cut their offerings following the September 11, 2001, terrorist attacks. When American Airlines closed its hubs in Nashville and San Jose, Southwest immediately increased the number of its flights into and out of both locations. When US Airways trimmed its flight schedule for Philadelphia and Pittsburgh, Southwest promptly boosted its flights into and out of those airports. Southwest initiated service to Denver when United, beset with financial difficulties, cut back operations at its big Denver hub.

- *Curtailing flights on marginally profitable routes where numerous seats often went unfilled and shifting planes to routes with good growth opportunities*—Managementw as attracted to this strategy element because it enabled Southwest to grow revenues and profits without having to add so many new planes to its fleet.
- *Putting strong emphasis on safety, high-quality maintenance, and reliable operations.*

Southwest management believed the company's low-fare strategy, coupled with frequent flights and friendly service, delivered "more value for less money" to customers rather than "less value for less money." Kelleher said, "Everybody values a very good service provided at a very reasonable price."[20]

Southwest's Efforts to Execute Its Low-Fare Strategy

Southwest management fully understood that low fares necessitated zealous pursuit of low operating costs and had, over the years, instituted a number of practices to keep its costs below those of rival carriers:

- The company operated only one type of aircraft—the Boeing 737—to minimize the size of spare parts inventories, simplify the training of maintenance and repair personnel, improve the proficiency and speed with which maintenance routines could be done, and simplify the task of scheduling planes for particular flights. Furthermore, as the launch customer for Boeing's 737-300, 737-500, and 737-700 models, Southwest acquired its new aircraft at favorable prices. See Exhibit 9 for statistics on Southwest's aircraft fleet.
- Southwest was the first major airline to introduce ticketless travel (eliminating the need to print and process paper tickets) and also the first to allow customers to make reservations and purchase tickets at the company's Web site (thus bypassing the

Exhibit 9

Southwest's Aircraft Fleet as of May 2008

TYPE OF AIRCRAFT*	NUMBER	SEATS
Boeing 737-300	189	137
Boeing 737-500	25	122
Boeing 737-700	313	137

OTHER STATISTICAL FACTS

Average age of aircraft fleet—close to 9 years

Average aircraft trip length—631 miles and an average duration of 1 hour and 51 minutes

Average aircraft utilization in 2008—7 flights per day and about 13 hours of flight time

Fleet size—1990: 106, 1995: 224, 2000: 344, 2008: 527

Firm orders for new aircraft—2008: 29, 2009: 20, 2010: 10, 2011–2014: 49

*In each case, Southwest was Boeing's launch customer for this model.

need to pay commissions to travel agents for handling the ticketing process and reducing staffing requirements at Southwest's reservation centers). Selling a ticket on its Web site cost Southwest roughly $1, versus $3–$4 for a ticket booked through its own internal reservation system and as much as $15 for tickets for business travelers purchased through travel agents and professional business travel partners. Ticketless travel accounted for more than 95 percent of all sales in 2007, and nearly 74 percent of Southwest's revenues were generated through sales at its Web site.

- The company deemphasized flights to congested airports, stressing instead serving airports near major metropolitan areas and in medium-sized cities. This helped produce better-than-average on-time performance and reduce the fuel costs associated with planes sitting in line on crowded taxiways or circling airports waiting for clearance to land; in addition, it allowed the company to avoid paying the higher landing fees and terminal gate costs at such high-traffic airports as Atlanta's Hartsfield International, Chicago's O'Hare, and Dallas–Fort Worth (DFW), where landing slots were controlled and rationed to those airlines willing to pay the high fees. In several cases, Southwest was able to compete on the perimeters of several big metropolitan areas by flying into nearby airports with less congested air space. For example, Southwest drew some Boston-area passengers away from Boston's Logan International by initiating service into nearby Providence, Rhode Island, and Manchester, New Hampshire. Southwest's preference for less congested airports also helped minimize total travel time for passengers—driving to the airport, parking, ticketing, boarding, and flight time.
- Southwest's point-to-point scheduling of flights was more cost-efficient than the hub-and-spoke systems used by rival airlines. Hub-and-spoke systems involved passengers on many different flights coming in from spoke locations (or perhaps another hub) to a central airport or hub within a short span of time and then connecting to an outgoing flight to their destination (a spoke location or another hub). Most flights arrived and departed a hub across a two-hour window, creating big peak-valley swings in airport personnel workloads and gate utilization—airport personnel and gate areas were very busy when hub operations were in full swing and then were underutilized in the interval awaiting the next round of inbound/outbound flights. In contrast, Southwest's point-to-point routes permitted scheduling aircraft so as to minimize the time aircraft were at the gate, currently approximately 25 minutes, thereby reducing the number of aircraft and gate facilities that would otherwise be required. Furthermore, with a relatively even flow of incoming/outgoing flights and gate traffic, Southwest could staff its terminal operations to handle a fairly steady workload across a day, whereas hub-and-spoke operators had to staff their operations to serve three or four daily peak periods.

- To economize on the amount of time it took terminal personnel to check passengers in and to simplify the whole task of making reservations, Southwest dispensed with the practice of assigning each passenger a reserved seat. Instead, for many years, passengers were given color-coded plastic cards with the letters A, B, or C when they checked in at the boarding gate. Passengers then boarded in groups, according to the color/letter on their card, sitting in whatever seat was open when they got on the plane—a procedure described by some as a "cattle call." Passengers who were particular about where they sat had to arrive at the gate early to get boarding cards and then had to make sure to be up front when it was their group's turn to board. In 2002, Southwest abandoned the use of plastic cards and began printing a big, bold A, B, or C on the boarding pass when the passenger checked in at the ticket counter; passengers then boarded in groups according to the letter on their boarding pass. In 2007–2008, in order to significantly reduce the time that passengers spent standing in line waiting for their group to board, Southwest introduced an enhanced boarding method that automatically assigned each passenger a specific number within the passenger's boarding group at the time of check-in; passengers then boarded the aircraft in that numerical order. All passengers could check in online up to 24 hours before departure time and print out a boarding pass, thus bypassing counter check-in (unless they wished to check baggage).
- Southwest flight attendants were responsible for cleaning up trash left by deplaning passengers and otherwise getting the plane presentable for passengers to board for the next flight. (Until recently, other carriers had cleaning crews come on board to perform this function; however, recurring losses at many airlines in 2001–2005 forced stringent cost-cutting measures, prompting most all airlines to cut out the use of cleaning crews and copy Southwest's practice.)
- Southwest did not have a first-class section in any of its planes and had no fancy clubs for its frequent flyers to relax in at terminals. No meals had ever been served on Southwest flights; passengers were offered beverages and snacks (a practice that made reprovisioning planes simple and quick). During 2001–2005, virtually all airlines discontinued meal service on domestic flights (except for first-class passengers) as a way to cut expenses; a few of Southwest's rivals had begun charging passengers $2 for coffee, soft drinks, and bottled water served duringf lights.
- Southwest offered passengers no baggage transfer services to other carriers—passengers with checked baggage who were connecting to other carriers to reach their destination were responsible for picking up their luggage at Southwest's baggage claim and then getting it to the check-in facilities of the connecting carrier. (Southwest only booked tickets involving its own flights; customers connecting to flights on other carriers had to book such tickets either through travel agents or the connecting airline.) Starting in 2008, Southwest's airline rivals began charging $25 to $50 for a second checked bag, and a few had instituted fees for the first checked bag.
- In mid-2001 Southwest implemented use of new software that significantly decreased the time required to generate optimal crew schedules and help improve on-time performance.
- Starting in 2001, Southwest began converting from cloth to leather seats; the team of Southwest employees that investigated the economics of the conversion concluded that an all-leather interior would be more durable and easier to maintain, more than justifying the higher initial costs.
- Southwest was a first-mover among major U.S. airlines in employing fuel hedging and derivative contracts to counteract rising prices for crude oil and jet fuel. Since 1998, the company's aggressive fuel hedging

strategy had produced fuel savings of about $3.5 billion over what it would have spent had it paid the industry's average price for jet fuel. These savings had been a huge contributor to the company's ongoing profitability; for example, in the second quarter of 2008, Southwest realized $511 million in favorable cash settlements from derivative contracts and reported net earnings of $321 million. (By comparison, Delta had hedged 49 percent of its fuel requirements and realized gains of $313 million on its fuel hedge contracts in the 2008 second quarter.) Southwest had derivative contracts for approximately 80 percent of its third-quarter 2008 estimated fuel consumption at an average crude-equivalent price of approximately $61 per barrel (compared to approximately 90 percent at approximately $51 per barrel for third-quarter 2007); crude oil prices were in the $110–$130 range in July–August 2008, but fell to the $90–$95 range in September 2008. Moreover, Southwest had derivative contracts in place for approximately 80 percent of its estimated fuel consumption for the fourth quarter of 2008 at an average crude-equivalent price of approximately $58 per barrel; approximately 70 percent in 2009 at an average crude-equivalent price of $66 per barrel; approximately 40 percent in 2010 at an average crude-equivalent price of approximately $81 per barrel; and over 20 percent in 2011 and 2012 at an average crude-equivalent price of approximately $77 and $76 per barrel, respectively.

- To enhance the performance and efficiency of its aircraft fleet, Southwest had recently added vertical winglets on the wing tips of most all its planes and had begun ordering new planes equipped with winglets (see Exhibit 8). These winglets reduced lift drag, allowed aircraft to climb more steeply and reach higher flight levels quicker, improved cruising performance, helped extend engine life and reduce maintenance costs, and reduced fuel burn. In 2007, Southwest partnered with Naverus, an aviation consulting firm, to develop new flight systems and procedures that would result in its planes being able to reduce fuel consumption, lower emissions, and curtail noise while simultaneously taking better advantage of the high-performance characteristics of its aircraft.
- In 2007–2008, Southwest began investing in technology and software to replace its ticketless system and its back-office accounting, payroll, and human resource information systems, so as to enhance data flow, operational efficiency, and customer service capability.

Southwest's operating costs were consistently the lowest of the major U.S. airline carriers—see Exhibit 10. Exhibit 11 shows a detailed breakdown of Southwest's operating costs for the period 1995–2007.

Southwest's People Management Practices and Culture

Whereas the litany at many companies was that customers come first, at Southwest the operative principle was that "employees come first and customers come second." The high strategic priority placed on employees reflected management's belief that delivering superior service required employees who not only were passionate about their jobs but also knew the company was genuinely concerned for their well-being and committed to providing them with job security. Southwest's thesis was simple: Keep employees happy—then they will keep customers happy. (The company changed the personnel department's name to the People Department in 1989.)

In Southwest's 2000 annual report, senior management explained why employees were the company's greatest asset:

> Our people are warm, caring and compassionate and willing to do whatever it takes to bring the Freedom to Fly to their fellow Americans. They take pride in doing well for themselves by doing good for others.

Exhibit 10

Comparative Operating Cost Statistics, Major U.S. Airlines, Selected Years 1995–First Quarter 2008 (in cents per passenger seat mile)

		COSTS INCURRED PER PASSENGER REVENUE MILE*									
		SALARIES AND FRINGE BENEFITS									
	YEAR	PILOTS AND COPILOTS	ALL EMPLOYEES	FUEL AND OIL	MAINTENANCE	RENTALS	LANDING FEES	ADVERTISING	GENERAL AND ADMINISTRATIVE	OTHER OPERATING EXPENSES	TOTAL OPERATING EXPENSES
America West†	**1995**	0.64¢	3.01¢	1.40¢	0.94¢	1.30¢	0.23¢	0.23¢	0.84¢	2.62¢	10.57¢
	2000	0.81	3.14	2.18	1.82	1.73	0.18	0.14	0.55	2.41	12.15
	2005	0.77	3.06	3.32	1.46	0.44	0.23	0.04	0.82	5.13	14.50
	2006	0.76	3.32	3.85	1.41	0.47	0.23	0.05	1.27	5.57	16.15
	2007	0.76	3.28	3.87	1.55	0.55	0.23	0.03	0.43	5.65	15.58
	Q1 2008†	—	—	—	—	—	—	—	—	—	—
American Airlines	**1995**	0.94¢	5.59¢	1.53¢	1.34¢	0.59¢	0.22¢	0.19¢	1.14¢	3.65¢	14.25¢
	2000	1.16	5.77	2.04	1.90	0.48	0.23	0.18	0.58	3.30	14.48
	2005	0.90	4.65	3.67	1.42	0.41	0.32	0.10	0.95	3.66	15.18
	2006	0.85	4.64	4.15	1.46	0.42	0.31	0.11	0.80	3.64	15.55
	2007	0.84	4.63	4.34	1.48	0.42	0.30	0.12	0.91	3.78	15.98
	Q1 2008	0.90	4.79	5.72	1.75	0.38	0.32	0.13	0.85	4.24	18.18
Continental Air Lines	**1995**	0.95¢	3.69¢	1.67¢	1.50¢	1.25¢	0.27¢	0.25¢	0.56¢	3.68¢	12.87¢
	2000	1.25	4.43	2.18	1.42	1.17	0.24	0.09	0.59	3.57	13.70
	2005	0.79	3.85	3.42	1.18	0.91	0.34	0.13	0.82	5.74	16.38
	2006	0.71	3.76	3.82	1.20	0.87	0.33	0.12	1.03	5.38	16.51
	2007	0.75	3.85	3.97	1.24	0.81	0.30	0.13	1.09	5.17	16.56
	Q1 2008	0.79	3.82	5.26	1.34	0.85	0.33	0.14	0.92	6.15	18.81
Delta Air Lines	**1995**	1.27¢	4.97¢	1.70¢	1.16¢	0.71¢	0.30¢	0.18¢	0.43¢	4.07¢	13.53¢
	2000	1.27	5.08	1.73	1.41	0.54	0.22	0.12	0.74	3.03	12.85
	2005	0.93	4.31	3.68	1.10	0.38	0.22	0.16	0.84	6.01	16.68
	2006	0.73	3.81	4.18	1.15	0.21	0.20	0.15	0.94	6.87	17.50
	2007	0.73	3.64	4.32	1.21	0.15	0.20	0.17	1.18	6.75	17.63
	Q1 2008	0.83	3.95	5.67	1.27	0.21	0.21	0.12	1.07	8.45	20.95

Exhibit 10 (continued)

Comparative Operating Cost Statistics, Major U.S. Airlines, Selected Years 1995–First Quarter 2008 (in cents per passenger seat mile)

		COSTS INCURRED PER PASSENGER REVENUE MILE*									
		SALARIES AND FRINGE BENEFITS									
	YEAR	PILOTS AND COPILOTS	ALL EMPLOYEES	FUEL AND OIL	MAINTENANCE	RENTALS	LANDING FEES	ADVERTISING	GENERAL AND ADMINISTRATIVE	OTHER OPERATING EXPENSES	TOTAL OPERATING EXPENSES
Northwest Airlines	**1995**	1.21¢	4.84¢	1.73¢	1.39¢	0.58¢	0.37¢	0.20¢	0.52¢	3.14¢	12.77¢
	2000	1.01	4.76	2.35	1.55	0.53	0.31	0.17	0.55	2.77	12.99
	2005	0.94	5.07	4.01	1.54	0.57	0.38	0.12	0.58	5.13	17.40
	2006	0.73	3.83	4.56	1.38	0.31	0.48	0.10	0.51	5.02	16.20
	2007	0.78	3.60	4.47	1.32	0.28	0.33	0.09	0.71	5.09	15.90
	Q1 2008	0.74	3.79	5.94	1.48	0.26	0.31	0.08	0.85	6.54	19.25
Southwest Airlines	**1995**	0.92¢	3.94¢	1.56¢	1.21¢	0.79¢	0.35¢	0.41¢	1.09¢	1.56¢	10.91¢
	2000	0.86	4.22	1.95	1.22	0.48	0.31	0.35	1.42	0.96	10.91
	2005	1.18	4.70	2.44	1.17	0.31	0.34	0.29	0.73	1.23	11.21
	2006	1.19	4.72	3.37	1.13	0.27	0.33	0.27	0.70	1.24	12.03
	2007	1.22	4.67	3.71	1.27	0.26	0.34	0.26	0.80	1.20	12.53
	Q1 2008	1.28	4.80	4.54	1.26	0.27	0.43	0.31	0.90	1.35	13.85
United Air Lines	**1995**	0.86¢	4.73¢	1.51¢	1.51¢	0.90¢	0.29¢	0.17¢	0.53¢	2.92¢	12.58¢
	2000	1.15	5.75	1.98	1.84	0.73	0.28	0.21	0.76	3.09	14.65
	2005	0.62	3.72	3.53	1.60	0.35	0.30	0.16	0.60	5.09	15.35
	2006	0.61	3.84	4.11	1.71	0.35	0.30	0.09	0.92	4.76	16.07
	2007	0.62	3.86	4.26	1.87	0.35	0.29	0.07	0.91	4.65	16.27
	Q1 2008	0.69	4.16	5.85	2.13	0.34	0.32	0.07	1.00	5.26	19.13
US Airways‡	**1995**	1.55¢	7.53¢	1.59¢	2.09¢	1.05¢	0.29¢	0.13¢	0.73¢	4.32¢	17.73¢
	2000	1.36	7.59	2.44	2.30	0.97	0.28	0.19	1.10	4.81	19.68
	2005	0.78	3.74	3.89	1.50	1.06	0.31	0.06	0.66	7.27	18.49
	2006	0.73	3.85	4.30	1.62	1.08	0.28	0.05	1.04	7.82	20.03
	2007	0.71	4.25	4.45	1.71	1.12	0.26	0.04	0.86	7.46	20.14
	Q1 2008	0.83	4.13	5.63	2.11	1.26	0.24	0.03	0.25	7.81	21.45

*Costs per passenger revenue mile represent the costs per ticketed passenger per mile flown; it is derived by dividing the company's total expenses in each of the cost categories by the total number of miles flown by all ticketed passengers—thus if there are 100 ticketed passengers on a flight that travels 500 miles, the number of passenger revenue miles for that flight is 100 × 500 (or 50,000).

†Merged with US Airways in 2005; combined reporting began in October 2007.

‡Merged with America West in September 2005; combined reporting began in October 2007.

Source: U.S. Department of Transportation, Bureau of Transportation Statistics, Air Carrier Statistics Form 298C Summary Data and Form 41, Schedules P-6, P-12, P-51, and P-52.

Exhibit 11

Trends in Southwest Airline's Operating Expenses per Average Seat Mile, 1995–2007

	Costs per Available Seat Mile								
EXPENSE CATEGORY	2007	2006	2005	2004	2003	2002	2001	2000	1995
Salaries, wages, bonuses, and benefits	3.22¢	3.29¢	3.27¢	3.18¢	3.10¢	2.89¢	2.84¢	2.81¢	2.40¢
Fuel and oil	2.55	2.31	1.58	1.30	1.16	1.11	1.18	1.34	1.01
Maintenance materials and repairs	0.62	0.51	0.52	0.60	0.60	0.57	0.61	0.63	0.60
Aircraft rentals	0.16	0.17	0.19	0.23	0.25	0.27	0.29	0.33	0.47
Landing fees and other rentals	0.56	0.53	0.53	0.53	0.52	0.50	0.48	0.44	0.44
Depreciation	0.56	0.56	0.55	0.56	0.53	0.52	0.49	0.47	0.43
Other expenses	1.43	1.43	1.41	1.37	1.44	1.55	1.65	1.71	1.72
Total	9.10¢	8.80¢	8.05¢	7.70¢	7.60¢	7.41¢	7.54¢	7.73¢	7.07¢

Note: Figures in this exhibit differ from those for Southwest in Exhibit 9 because the cost figures in Exhibit 9 are based on *cost per passenger revenue mile,* whereas the cost figures in this exhibit are based on *costs per available seat mile.* Costs per revenue passenger mile represent the costs per ticketed passenger per mile flown, whereas costs per available seat mile are the *costs per seat per mile flown (irrespective of whether the seat was occupied or not).*

Source: Company 10-K reports and annual reports.

> They have built a unique and powerful culture that demonstrates that the only way to accomplish our mission to make air travel affordable for others, while ensuring ample profitability, job security, and plentiful Profitsharing for ourselves, is to keep our costs low and Customer Service quality high.
>
> At Southwest, our People are our greatest assets, which is why we devote so much time and energy to hiring great People with winning attitudes. Because we are well known as an excellent place to work with great career opportunities and a secure future, lots of People want to work for Southwest. . . . Once hired, we provide a nurturing and supportive work environment that gives our Employees the freedom to be creative, have fun, and make a positive difference. Although we offer competitive compensation packages, it's our Employees' sense of ownership, pride in team accomplishments, and enhanced job satisfaction that keep our Culture and Southwest Spirit alive and why we continue to produce winning seasons.

CEO Gary Kelly echoed the views of his predecessors: "Our People are our single greatest strength and our most enduring long term competitivead vantage."[21]

Recruiting,S creening, and Hiring

Southwest hired employees for attitude and trained for skills. Kelleher explained:

> We can train people to do things where skills are concerned. But there is one capability we do not have and that is to change a person's attitude. So we prefer an unskilled person with a good attitude . . . [to] a highly skilled person with a bad attitude.[22]

Management believed that delivering superior service came from having employees who treated customers warmly and courteously; the company wanted employees who genuinely believed that customers were important, not employees who had merely been trained to *act* like customers were important. The belief at Southwest was that superior, hospitable service and a fun-loving spirit flowed from the heart and soul of employees who themselves were fun-loving and spirited, who liked their jobs and the company they worked for, and who were also confident and empowered to do their jobs as they saw fit (rather than being governed by strict rules and procedures).

Southwest recruited employees by means of newspaper ads, career fairs, and Internet job listings; a number of candidates applied because of Southwest's reputation as one of the best companies to work for in America and because they were impressed by their experiences as a customer on Southwest flights. Recruitment ads were designed to capture the attention of people thought to possess Southwest's "personality profile." For instance, one ad showed Herb Kelleher impersonating Elvis Presley and had the following headline: "Work In A Place Where Elvis Has Been Spotted." The body of the ad read:

> The qualifications? It helps to be outgoing. Maybe even a bit off center. And be prepared to stay for a while. After all, we have the lowest employee turnover rate in the industry. If this sounds good to you, just phone our jobline or send your resume. AttentionEl vis.[23]

Colleen Barrett elaborated on what the company looked for in screening candidates for job openings:

> We hire People to live the Southwest Way [see Exhibit 12]. They must possess a Warrior Spirit, lead with a Servant's Heart, and have a Fun-LUVing attitude. We hire People who fight to win, work hard, are dedicated, and have a passion for Customer Service. We won't hire People if something about their behavior won't be a Cultural fit. We hire the best. When our new hires walk through the door, our message to them is you are starting the flight of your life.[24]

All job applications were processed through the People and Leadership Development Department.

SCREENING CANDIDATES In hiring for jobs that involved personal contact with passengers, the company looked for people-oriented applicants who were extroverted and had a good sense of humor. It tried to identify candidates with a knack for reading peoples' emotions and responding in a genuinely caring, empathetic manner. Southwest wanted employees to deliver the kind of service that showed they truly enjoyed meeting people, being around passengers, and doing their job, as opposed to delivering the kind of service that came across as being forced or taught. According to Kelleher, "We are interested in people who externalize, who focus on other people, who are motivated to help other people. We are not interested in navel gazers."[25] Southwest was drawn to candidates who not only presented a "whistle while you work" attitude but also appeared likely to exercise initiative, work harmoniously with fellow employees, and be community-spirited.

Southwest did not use personality tests to screen job applicants, nor did it ask applicants what they would or should do in certain hypothetical situations. Rather, the hiring staff at Southwest analyzed each job category to determine the specific behaviors, knowledge, and motivations that job holders needed and then tried to find candidates with the desired traits—a process called targeted selection. A trait common to all job categories was teamwork; a trait deemed critical for pilots and flight attendants was judgment. In exploring an applicant's aptitude for teamwork, interviewers often asked applicants to tell them about a time in a prior job when they went out of their way to help a coworker or to explain how they had handled conflict with a coworker. Another frequent question was "What was your most embarrassing moment?" The thesis here was that having applicants talk about their past behaviors provided good clues about their future behaviors.

To test for unselfishness, Southwest interviewing teams typically gave a group of potential employees ample time to prepare five-minute presentations about themselves; during the presentations in an informal conversational setting, interviewers watched the audience to see who was absorbed in polishing their presentations and who was listening attentively, enjoying the stories being told, and applauding the efforts of the presenters. Those who were emotionally engaged in hearing the presenters and giving encouragement were deemed more apt to be team players than those who were focused on looking good themselves. All applicants for flight attendant positions were put through such a presentation exercise before an interview panel consisting of customers, experienced flight attendants, and members of the People Department. Flight attendant candidates who got through the group presentation interviews then had to complete a three-on-one interview conducted by a recruiter, a supervisor from the hiring section of the People Department, and a Southwest flight attendant; following this interview, the three-person panel tried to reach a consensus on whether to recommend or drop the candidate.

In 2007, Southwest received 329,200 résumés and hired 4,200 new employees.

Training

Apart from the FAA-mandated training for certain employees, training activities at Southwest were designed and conducted by Southwest's University for People. The curriculum included courses for new recruits, employees, and managers. Learning was viewed as a never-ending process for all company personnel; the expectation was that each employee should be an "intentional learner," looking to grow and develop not just from occasional classes taken at Southwest's festive University for People learning center but also from their everyday on-the-job experiences.

Southwest's University for People conducted courses on safety, communications, stress management, career development, performance appraisal, decision making, leadership, corporate culture, and employee relations. Leadership courses for managers emphasized a management style based on coaching, empowering, and encouraging, rather than supervising or enforcing rules and regulations. One of the keystone course offerings for managers was Leadership Southwest Style, which made extensive use of the Myers-Briggs personality assessment to help managers understand the "why" behind coworkers' behaviors and to learn how to build trust, empathize, resolve conflicts, and do a better job of communicating. From time to time supervisors and executives attended courses on corporate culture, intended to help instill, ingrain, and nurture such cultural themes as teamwork, trust, harmony, and diversity. All employees who came into contact with customers, including pilots, received customer care training.

Orientation for new employees included videos on Southwest's history, an overview of the airline industry and the competitive challenges that Southwest faced, and an introduction to Southwest's culture and management practices. The culture introduction included a video called *The Southwest Shuffle* that featured hundreds of Southwest employees rapping about the fun they had on their jobs. (At many Southwest gatherings, it was common for a group of employees to do the Southwest Shuffle, with the remaining attendees cheering and clapping.) There were also exercises that demonstrated the role of creativity and teamwork and a scavenger hunt in which new hires were given a time line with specific dates in Southwest's history and asked to fill in the missing details by viewing the memorabilia decorating the corridors of the Dallas headquarters and getting information from people working in various offices. Much of the indoctrination of new employees into the company's culture was done by coworkers and the employee's supervisor. Southwest made active use of a one-year probationary employment period to help ensure that new employees fit in with its culture and adequately embraced the company's cultural values.

THE ONBOARDING PROGRAM FOR NEWLY HIRED EMPLOYEES Southwest had an employee orientation program called OnBoarding designed to provide new hires with information and assistance from the time they were selected until the end of their first year. During their first 30 days at Southwest, new employees could access an interactive online tool—OnBoarding Online Orientation—to learn about the company.

Promotion

Approximately 80 to 90 percent of Southwest's supervisory positions were filled internally, reflecting management's belief that people who had "been there and done that" would be more likely to appreciate and understand the demands that people under them were experiencing and also be more likely to enjoy the respect of their peers and higher-level managers. Employees could either apply for supervisory positions or be recommended by their present supervisor. New appointees for low-level management positions attended a three-day class called Leading with Integrity, aimed at developing leadership and communication skills. Employees being considered for managerial positions of large operations (deemed "Up and Coming Leaders") received training in every department of the company over a six-month period in which they continued to perform their current job. At the end of the six-month period, candidates were provided with 360-degree feedback from department heads, peers, and subordinates; representatives of the People Department analyzed the feedback in deciding on the specific assignment of each candidate.[26]

Compensation

Southwest's pay scales tended to be above the industry average—sometimes even at or near the top of the industry, and the company offered good benefit packages relative to other airlines. In 2008, median hourly pay at Southwest was in the neighborhood of $31 for flight attendants, $40 for aircraft mechanics and service technicians, $24 for customer service representatives and baggage handlers, $20 for cargo and freight agents, $95 for flight engineers and copilots, and $135 for commercial pilots.[27] Pay scales for the company's 6,800 ramp agents, operations agents, provision agents, and freight agents—all of whom were represented by the Transport Workers Union—were said to be the highest in U.S. airline industry.[28] Southwest was also an industry leader in total compensation of pilots and flight attendants.

Southwest introduced a profit-sharing plan for senior employees in 1973, the first such plan in the airline industry. By the mid-1990s the plan had been extended to cover most Southwest employees. As of 2008, Southwest had stock option programs for various employee groups, a 401(k) employee savings plans that included company-matching contributions, and a profit-sharing plan covering virtually all employees that consisted of a money purchase defined contribution plan and an employee stock purchase plan. Company contributions to employee 410(k) and profit-sharing plans totaled $241.5 million in 2000, $264 million in 2005, $301 million in 2006, and $279 million in 2007; in recent years, these payments had represented 8 to 12 percent of base pay. Employees participating in stock purchases via payroll deduction bought 677,000 shares in 1998, 686,000 shares in 2000, 1.5 million shares in 2005, and 1.3 million shares in 2007 at prices equal to 90 percent of the market value at the end of each monthly purchase period. Southwest employees owned about 10 percent of Southwest's outstanding shares and held options to buy some 28.5 million additionals hares.

EmployeeR elations

About 80 percent of Southwest's 34,300 employees belonged to a union, making it one of the most highly unionized U.S. airlines. The Teamsters Union represented Southwest's airline mechanics, stock clerks, and aircraft cleaners; the Transport Workers Union represented flight attendants; Local 555 of the Transport Workers Union represented baggage handlers, ground crews, and provisioning employees; and the International Association of Machinists represented the customer service and reservation employees. There was one in-house union—the Southwest Airline Pilots Association that represented the company's 5,400 pilots. Despite having sometimes spirited disagreements over particular issues, Southwest and the unions representing its employee groups had harmonious and nonadversarial relationships for the most part—the company had experienced only one brief strike by machinists in the early 1980s.

Management encouraged union members and negotiators to research their pressing issues and to conduct employee surveys before each contract negotiation. Southwest's contracts with the unions representing its employees were relatively free of restrictive work rules and narrow job classifications that might impede worker productivity. All of the contracts allowed any qualified employee to perform any function—thus, pilots, ticket agents, and gate personnel could help load and unload baggage when needed and flight attendants could pick up trash and make flight cabins more presentable for passengers boarding the next flight.

In 2000–2001, the company had contentious negotiations with Local 555 of the Transport Workers Union (representing about 5,300 Southwest employees) over a new wage and benefits package; the previous contract had become open for renegotiation in December 1999 and a tentative agreement reached at the end of 2000 was rejected by 64 percent of the union members who voted. A memo from Kelleher to TWU representatives said, "The cost and structure of the TWU 555 negotiating committee's proposal would seriously undermine the competitive strength of Southwest Airlines; endanger our ability to grow; threaten the value of our employees' profit-sharing; require us to contract out work in order to remain competitive; and threaten our 29-year history of job security for our employees." In a union newsletter in early 2001, the president of the TWU said, "We asked for a decent living wage and benefits to support our families, and were told of how unworthy and how greedy we were." The ongoing dispute resulted in informational picket lines in March 2001 at several Southwest locations, the first picketing since 1980. Later in 2001, with the help of the National Mediation Board, Southwest and the TWU reached an agreement covering Southwest's ramp, operations, and provisioning employees.

Prior to the September 11, 2001, terrorist attacks, Southwest's pilots were somewhat restive about their base pay relative to pilots at other U.S. airlines. The maximum pay for Southwest's 3,700-plus pilots (before profit-sharing bonuses) was $148,000, versus maximums of $290,000 for United's pilots, $262,000 for Delta's pilots, $206,000 for American's pilots, and $199,000 for Continental's pilots.[29] Moreover, some veteran Southwest employees were grumbling about staff shortages in certain locations (to hold down labor costs) and cracks in the company's close-knit family culture due to the influx of so many new employees over the past several years. A number of employees who had accepted lower pay because of Southwest's underdog status were said to feel entitled to "big airline" pay now that Southwest had emerged as a major U.S. carrier.[30] However, when airline traffic dropped precipitously following 9/11, airlines won big wage and salary concessions from unions representing pilots and other airline workers; moreover, about one in five airline jobs—some 120,000 in all—were eliminated. In 2006, a senior Boeing 737 pilot at Delta Air Lines working a normal 65-hour month made $116,200 annually, down 26 percent from pre-9/11 wages. A comparable pilot at United Airlines earned $102,200, down 34 percent from before 9/11 and at American Airlines, such a pilot made $122,500, 18 percent less than the days before 9/11. As of 2006–2007, Southwest pilots were quite well paid compared to their counterparts at most other airlines, earning about 45 percent more than pilots at United Airlines and 18 percent more than pilots at American Airlines. In 2007–2008, Southwest and its pilots' union were in the process of negotiating a new agreement.

In 2004 and 2007, in an attempt to contain rising labor costs, Southwest offered voluntary buyout packages to approximately 8,700 flight attendants, ramp workers, customer service employees, and those in reservations, operations, and freight who had reached a specific pay scale; the buyout consisted of a $25,000 payment and medical and dental benefits for a specified period. About 1,000 employees accepted the 2004 buyout offer. In some cases, the employees who accepted the buyout were not replaced; in cases where replacements were needed, Southwest was able to hire new employees for lesser pay than the departing employees were earning (because only employees who were at or near the top of their pay grade—due to good job performance and length of service with the company—were offered buyouts).

The No-Layoff Policy

Southwest Airlines had never laid off or furloughed any of its employees since the company began operations in 1971. The no-layoff policy was seen as integral to how the company treated its employees and to management efforts to sustain and nurture the culture. According to Kelleher:

> Nothing kills your company's culture like layoffs. Nobody has ever been furloughed here, and that is unprecedented in the airline industry. It's been a huge strength of ours. It's certainly helped negotiate our union contracts. . . . We could have furloughed at various times and been more profitable, but I always thought that was shortsighted. You want to show your people you value them and you're not going to hurt them just to get a little more money in the short term. Not furloughing people breeds loyalty. It breeds a sense of security. It breeds a sense of trust.[31]

Southwest had built up considerable goodwill with its employees and unions over the years by avoiding layoffs. Both senior management and Southwest employees regarded the two recent buyout offers as a better approach to workforce reduction than involuntary layoffs.

Operation Kick Tail

In 2007, Southwest management launched an internal initiative called Operation Kick Tail, a multiyear call to action for employees to focus even more attention on providing high-quality customer service, maintaining low costs, and nurturing the Southwest culture. One component of Operation Kick Tail involved singling out employees for special recognition when they did something to make a positive difference in a customer's travel experience or in the life of a coworker.

CEO Gary Kelly saw this aspect of Operation Kick Tail as a way to foster the employee attitudes and commitment needed to fulfill Southwest's promise of "Positively Outrageous Customer Service"; he explained:

> One of Southwest's rituals is finding and developing People who are "built to serve." That allows us to provide a personal, warm level of service that is unmatched in the airline industry.

Management Style

At Southwest, management strived to do things in a manner that would make Southwest employees proud of the company they worked for. Managers were expected to spend at least one-third of their time out of the office, walking around the facilities under their supervision, observing firsthand what was going on, listening to employees, and being responsive to their concerns. A former director of people development at Southwest told of a conversation he had with one of Southwest's terminal managers:

> While I was out in the field visiting one of our stations, one of our managers mentioned to me that he wanted to put up a suggestion box. I responded by saying that, "Sure—why don't you put up a suggestion box right here on this wall and then admit you are a failure as a manager?" Our theory is, if you have to put up a box so people can write down their ideas and toss them in, it means you are not doing what you are supposed to be doing. You are supposed to be setting your people up to be winners. To do that, you should be there listening to them and available to them in person, not via a suggestion box. For the most part, I think we have a very good sense of this at Southwest. I think that most people employed here know that they can call any one of our vice presidents on the telephone and get heard, almost immediately.
>
> The suggestion box gives managers an out; it relinquishes their responsibility to be accessible to their people, and that's when we have gotten in trouble at Southwest—when we can no longer be responsive to our flight attendants or customer service agents, when they can't gain access to somebody who can give them resources and answers.[32]

Company executives were very approachable, insisting on being called by their first names. At new employee orientations, people were told, "We do not call the company chairman and CEO Mr. Kelly; we call him Gary." Managers and executives had an open-door policy, actively listening to employee concerns, opinions, and suggestions for reducing costs and improving efficiency.

Employee-led initiatives were common. Southwest's pilots had been instrumental in developing new protocols for takeoffs and landings that conserved fuel. Another frontline employee had suggested not putting the company logos on trash bags, saving an estimated $250,000 annually. Rather than buy 800 computers for a new reservations center in Albuquerque, company employees determined that they could buy the parts and assemble the computers themselves for half the price of new ones, saving the company $1 million. It was Southwest clerks who came up with the idea of doing away with paper tickets and shifting to e-tickets.

There were only four layers of management between a frontline supervisor and the CEO. Southwest's employees enjoyed substantial authority and decision-making power. According to Kelleher:

> We've tried to create an environment where people are able to, in effect, bypass even the fairly lean structures that we have so that they don't have to convene a meeting of the sages in order to get something done. In many cases, they can just go ahead and do it on their own. They can take individual responsibility for it and know they will not be crucified if it doesn't work out. Our leanness requires people to be comfortable in making their own decisions and undertaking their own efforts.[33]

From time to time, there were candid meetings of frontline employees and managers where operating problems and issues among workers and departments were acknowledged, openly discussed, and resolved.[34] Informal problem avoidance and rapid problem resolution were seen as managerial virtues.

Southwest'sC ore Values

Two core values—LUV and fun—permeated the work environment at Southwest. LUV was much more than the company's ticker symbol and a recurring theme in Southwest's advertising campaigns. Over the years, LUV grew into Southwest's code word for treating individuals—fellow employees and customers—with dignity and respect and demonstrating a caring, loving attitude. LUV and red hearts commonly appeared on banners and posters at company facilities, as reminders of the compassion that was expected toward customers and other employees. Practicing the Golden Rule, internally and externally, was expected of all employees. Employees who struggled to live up to these expectations were subjected to considerable peer pressure and usually were asked to seek employment elsewhere if they did not soon leave on their own volition.

Fun at Southwest was exactly what the word implies. Throughout the company, fun appeared in the form of the generally entertaining behavior of employees in performing their jobs, the ongoing pranks and jokes, and frequent company-sponsored parties and celebrations (which typically included the Southwest Shuffle). On holidays, employees were encouraged to dress in costumes. There were charity benefit games, chili cook-offs, Halloween parties, new Ronald McDonald House dedications, and other special events of one kind or another at one location or another almost every week. According to one manager, "We're kind of a big family here, and family members have funt ogether."

Culture-Building

Southwest executives believed that the company's growth was primarily a function of the rate at which it could hire and train people to fit into its culture, to mirror the Southwest Spirit, and to consistently display the traits that comprised the Southwest Way (see Exhibit 12). CEO Gary Kelly said, "Some things at Southwest won't change. We will continue to expect our people to live what we describe as the 'Southwest Way,' which is to have a Warrior Spirit, Servant's Heart, and Fun-Loving Attitude. Those three things have defined our culture for 36y ears."[35]

Exhibit 12

Personal Traits, Attitudes, and Behaviors That Southwest Wanted Employees to Possess and Display

LIVE THE SOUTHWEST WAY		
WARRIOR SPIRIT	**SERVANT'S HEART**	**FUN-LUVING ATTITUDE**
• Work hard	• Follow the Golden Rule	• Have FUN
• Desire to be the best	• Adhere to the Basic Principles	• Don't take yourself too seriously
• Be courageous	• Treat others with respect	• Maintain perspective (balance)
• Display a sense of urgency	• Put others first	• Celebrate successes
• Persevere	• Be egalitarian	• Enjoy your work
• Innovate	• Demonstrate proactive Customer Service	• Be a passionate team player
	• Embrace the SWA Family	

Source: www.southwest.com (accessed September 5, 2008).

THE CULTURE COMMITTEE Southwest formed a Culture Committee in 1990 to promote "Positively Outrageous Service" and devise tributes, contests, and celebrations intended to nurture and perpetuate the Southwest Spirit. The committee, chaired by Colleen Barrett until mid-2008, was composed of 100 employees who had demonstrated their commitment to Southwest's mission and values and zeal in exhibiting the Southwest Spirit. Members came from a cross-section of departments and locations and functioned as cultural ambassadors, missionaries, and storytellers during their two-year term.

The Culture Committee had four all-day meetings annually; ad hoc subcommittees formed throughout the year met more frequently. Over the years, the committee had sponsored and supported hundreds of ways to promote and ingrain the Southwest Spirit—examples included promoting the use of red hearts and LUV to embody the spirit of caring, serving pizza or ice cream to employees, or remodeling an employee break room. Kelleher indicated, "We're not big on committees at Southwest, but of the committees we do have, the Culture Committee is the most important."[36]

EFFORTS TO NURTURE AND SUSTAIN THE SOUTHWEST CULTURE Apart from the efforts of the Culture Committee, Southwest management had sought to reinforce the company's core values and culture via an annual Heroes of the Heart Award, a mentoring program called CoHearts, an event called Day in the Field during which employees spent time working in another area of the company's operations, a program called Helping Hands that gathered volunteers from around the system to work two weekend shifts at other Southwest facilities that were temporarily shorthanded or experiencing heavy workloads, and periodic meetings called Culture Exchange to celebrate the Southwest Spirit and company milestones. Almost every event at Southwest was videotaped, which provided footage for creating such multipurpose videos as *Keepin' the Spirit Alive* that could be shown at company events all over the system and used in training courses. The concepts of LUV and fun were spotlighted in all of the company's training manuals and videos.

Southwest's monthly newsletter, *LUV Lines*, often spotlighted the experiences and deeds of particular employees, reprinted letters of praise from customers, and reported company celebrations of milestones. A quarterly news video, *As the Plane Turns*, was sent to all facilities to keep employees up to date on company happenings, provide clips of special events, and share messages from customers, employees, and executives. The company had published a book for employees describing "outrageous" acts of service. Sometimes important information was circulated to employees in "fun" packages such as Cracker Jack boxes.

EmployeeP roductivity

Management was convinced the company's strategy, culture, esprit de corps, and people management practices fostered high labor productivity and contributed to Southwest having very low labor costs compared to other airlines (as shown in Exhibit 10). When a Southwest flight pulled up to the gate, ground crews, gate personnel, and flight attendants hustled to perform all the tasks requisite to turn the plane quickly—employees took pride in doing their part to achieve good on-time performance. Southwest's turnaround times were in the 25- to 30-minute range, versus an industry average of around 45 minutes. In 2007, Southwest's labor productivity compared favorably with the U.S. airline average:

PRODUCTIVITY MEASURE	SOUTHWEST	U.S. AIRLINE INDUSTRY AVERAGE
Passengers enplaned per employee, 2007	2,964	1,371
Employees per plane, 2007	65.2	71.8

SystemO perations

Under Herb Kelleher, instituting practices and support systems that promoted operating excellence had become a tradition and a source of company pride. Much time and effort over the years had gone into finding the most effective ways to do aircraft maintenance, to operate safely, to make baggage handling more efficient and baggage transfers more accurate, and to improve the percentage of on-time arrivals and departures. Believing that air travelers were more likely to fly Southwest if its flights were reliable and on time, Southwest's managers constantly monitored on-time arrivals and departures, making inquiries when many flights ran behind and searching for ways to improve on-time performance. One initiative to help minimize weather and operational delays involved the development of a state-of-the-art flight dispatch system. CEO Gary Kelly had followed Kelleher's lead in pushing for operational excellence. One of Kelly's strategic objectives was for Southwest "to be the safest, most efficient, and most reliable airline in the world." Southwest managers and employees in all positions and ranks were proactive in offering suggestions for improving Southwest's practices and procedures; those with merit were quickly implemented. Southwest was considered to have one of the most competent and thorough aircraft maintenance programs in the commercial airline industry and, going into 2008, was widely regarded as the best operator among U.S. airlines. Its recent record vis-à-vis rival airlines on four important measures of operating performance was commendable—see Exhibit 13.

THE FIRST SIGNIFICANT BLEMISH ON SOUTHWEST'S SAFETY RECORD

While no Southwest plane had ever crashed and there had never been a passenger fatality, there was an incident in 2005 in which a Southwest plane landing in a snow storm with a strong tailwind at Chicago's Midway airport was unable to stop before overrunning a shorter-than-usual runway, rolling onto a highway, crashing into a car, killing one of the occupants, and injuring 22 of the passengers on the plane. A National Traffic Safety Board investigation concluded that "the pilot's failure to use available reverse thrust in a timely manner to safely slow or stop the airplane after landing" was the probable cause.

BELATED AIRCRAFT INSPECTIONS FURTHER TARNISH SOUTHWEST'S REPUTATION In early 2008, various media reported that Southwest Airlines over a period of several months in 2006 and 2007 had knowingly failed to conduct required inspections for early detection of fuselage fatigue cracking on 46 of its older Boeing 737-300 jets. The company

Exhibit 13

Comparative Statistics on On-Time Flights, Mishandled Baggage, Oversales, and Passenger Complaints for Seven Major U.S. Airlines, 2000, 2005–First Quarter 2008

PERCENTAGE OF SCHEDULED FLIGHTS ARRIVING WITHIN 15 MINUTES OF SCHEDULED TIME (PREVIOUS 12 MONTHS ENDING IN MAY OF EACH YEAR)

AIRLINE	2000	2005	2006	2007	Q1 2008
American Airlines	75.8 %	78.0 %	75.6 %	72.4 %	66.9 %
Continental Air Lines	76.7	78.7	74.8	73.5	74.1
Delta Air Lines	78.3	76.4	76.2	76.6	75.7
Northwest Airlines	80.7	79.3	75.1	71.4	71.1
Southwest Airlines	78.7	79.9	80.3	80.7	78.5
United Air Lines	71.6	79.8	75.7	73.0	69.1
US Airways	72.7	76.0	78.9	69.7	75.5

MISHANDLED BAGGAGE REPORTS PER 1,000 PASSENGERS (IN MAY OF EACH YEAR)

AIRLINE	2000	2005	2006	2007	Q1 2008
American Airlines	5.44	4.58	4.91	6.40	5.82
Continental Air Lines	4.11	3.30	3.85	5.02	3.78
Delta Air Lines	3.64	6.21	4.75	5.26	3.81
Northwest Airlines	4.98	3.58	3.11	3.80	2.97
Southwest Airlines	4.14	3.46	3.66	5.54	4.41
United Air Lines	6.71	4.00	3.89	4.83	4.76
US Airways	4.57	9.73	5.69	7.17	3.86

INVOLUNTARY DENIED BOARDINGS PER 10,000 PASSENGERS DUE TO OVERSOLD FLIGHTS (JANUARY THROUGH MARCH OF EACH YEAR)

AIRLINE	2000	2005	2006	2007	Q1 2008
American Airlines	0.59	0.72	1.16	1.06	0.98
Continental Air Lines	0.50	3.01	2.60	1.93	1.57
Delta Air Lines	0.44	1.06	2.68	3.47	1.80
Northwest Airlines	0.12	1.70	1.00	1.25	1.15
Southwest Airlines	1.70	0.74	1.81	1.25	1.68
United Air Lines	1.61	0.42	0.88	0.40	0.89
US Airways	0.80	1.01	1.07	1.68	2.01

COMPLAINTS PER 100,000 PASSENGERS BOARDED (IN MAY OF EACH YEAR)

AIRLINE	2000	2005	2006	2007	Q1 2008
American Airlines	2.77	1.01	1.22	1.44	1.30
Continental Air Lines	2.25	0.89	0.85	0.75	1.03
Delta Air Lines	1.60	0.91	0.93	1.50	2.14
Northwest Airlines	2.17	0.83	0.69	1.13	0.92
Southwest Airlines	0.41	0.17	0.18	0.19	0.32
United Air Lines	5.07	0.87	1.19	2.00	1.61
US Airways	1.63	0.99	1.22	2.65	1.94

Source: Office of Aviation Enforcement and Proceedings, Air Travel Consumer Report, various years.

had voluntarily notified the Federal Aviation Administration (FAA) about the lapse in checks for fuselage cracks but continued to fly the planes until the work was done—about eight days. The belated inspections revealed tiny cracks in the bodies of six planes, with the largest measuring four inches; none impaired flight safety. According to Gary Kelly, "Southwest Airlines discovered the missed inspection area, disclosed it to the FAA, and promptly re-inspected all potentially affected aircraft in March 2007. The FAA approved our actions and considered the matter closed as of April 2007." Nonetheless, on March 12, 2008, shortly after the reports in the media surfaced about Southwest not meeting inspection deadlines, Southwest canceled 4 percent of its flights and grounded 44 of its Boeing 737-300s until it verified that the aircraft had undergone required inspections. Kelly then initiated an internal review of the company's maintenance practices; the investigation raised concerns about the company's aircraft maintenance procedures, prompting Southwest to put three employees on leave. The FAA subsequently fined Southwest $10.2 million for its transgressions. In an effort to help restore customer confidence, Kelly publicly apologized for the company's wrongdoing, promised that it would not occur again, and reasserted the company's commitment to safety; he said:

> From our inception, Southwest Airlines has maintained a rigorous Culture of Safety—and has maintained that same dedication for more than 37 years. It is and always has been our number one priority to ensure safety.
>
> We've got a 37-year history of very safe operations, one of the safest operations in the world, and we're safer today than we've everb een.

In the days following the public revelation of Southwest's maintenance lapse and the tarnishing of its reputation, an industrywide audit by the FAA revealed similar failures to conduct timely inspections for early signs of fuselage fatigue at five other airlines—American, Continental, Delta, United, and Northwest. An air travel snafu ensued, with more than 1,000 flights subsequently being canceled due to FAA-mandated grounding of the affected aircraft while the overdue safety inspections were performed. Further public scrutiny, including a congressional investigation, turned up documents indicating that in some cases planes flew for 30 months after the inspection deadlines had passed. Moreover, high-level FAA officials were apparently aware of the failure of Southwest and other airlines to perform the inspections for fuselage skin cracking at the scheduled times and chose not to strictly enforce the inspection deadlines—according to some commentators, because of allegedly cozy relationships with personnel at Southwest and the other affected airlines. Disgruntled FAA safety supervisors in charge of monitoring the inspections conducted by airline carriers testified before Congress that senior FAA officials frequently ignored their reports that certain routine safety inspections were not being conducted in accordance with prescribed FAA procedures. Shortly thereafter, the FAA issued more stringent procedures to ensure that aircraft safety inspections were properly conducted.

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Case 15

Countrywide Financial Corporation and the Subprime Mortgage Debacle

RonaldW . Eastburn
CaseW esternRe serveU niversity

Angelo Mozilo, founder and Chairman of Countrywide Financial Corporation, was the driving force behind the company's efforts to become the largest real estate mortgage originator in the United States and, according to some, was also the driving force behind the company's eventual collapse. Mozilo and partner, David Loeb, founded Countrywide in 1969 in New York with the strategic intent of creating a nationwide mortgage lending firm. The company opened a retail branch in California in 1974 and, by 1980, had 40 offices in eight states. Mozilo and Loeb launched a securities subsidiary in 1981 that specialized in the sale of mortgage-backed securities (MBSs).[1] The company's annual loan production exceeded $1 billion in 1985 and began to grow at dramatic annual rates on the back of the U.S. housing market bubble which began in 1994 and ended in 2006. The company's greatest number of annual loan originations had occurred by the time of David Loeb's death in 2003, with more than 2.5 million mortgage originations that year. Countrywide Financial Corporation originated more than 2.2 million loans totaling $408 billion in 2006. By 2007, the company had 661 branches in 48 states and, in July 2008, was acquired by Bank of America (BoA) for $4 billion in an all-stock transaction. The market value of the company had reached $24 billion in 2006, but fell rapidly in 2007 when it became evident that many of the mortgages Countrywide made during the housing boom were overly risky and likely to go into default.

Problems with Countrywide's loan portfolio and lending practices were evident to BoA management even before the acquisition was consummated, with BoA investing over $2 billion in Countrywide in return for a 16 percent stake in the company in August 2007 to stabilize the troubled mortgage firm's balance sheet. Shortly after the acquisition BoA management agreed to enter into an $8.7 billion settlement with a group of state attorneys general over Countrywide Financial Corporation's (CFC) predatory lending practices. BoA allowed Mozilo to retire from the Countrywide's management team and, in June 2009, the Securities and Exchange Commission (SEC) indicted Mozilo and two other key CFC executives for fraudulent misrepresentation of the credit and market risk inherent in CFC's loan portfolio.

Investigation of Countrywide's business practices disclosed how the real estate market supported by U.S. federal legislative and regulatory decisions fostered an environment that resulted in the collapse of Fannie Mae and Freddie Mac, major banking institutions, Wall Street investment firms, and mortgage brokerage firms. The financial crisis of 2008 had at its foundation subprime mortgages, mortgage-backed securities, and capital markets activity, and as the nation's largest mortgage lender, CFC was a significant contributor to the subprime mortgage debacle. As the financial and credit crisis continued to play out into 2009, BoA executives would need to ensure that lending practices at all of its subsidiaries would promote homeownership in a manner that was in the best interest of borrowers, investors in the secondary mortgage market, and the company's own long-term financial interests.

Historyo f Mortgage Lending in the United States

Before the Great Depression, home mortgage instruments in the United States were typically of short term (3–10 years) with loan-to-value (LTV) ratios of about 60 percent. Loans at the time were nonamortizing and required a balloon payment at the expiration of the term. Mortgages were available to a limited client base, with home ownership representing about 40 percent of U.S. households. Many of these short-term mortgages went into default during the Great Depression as homeowners became unable to make regular payments or find new financing to pay off balloon payments that became due.

The United States government intervened in the housing market in 1932 with the creation of the Federal Home Loan Bank (FHLB). The FHLB provided short-term lending to financial institutions (primarily Savings and Loans) to create additional funds for home mortgages. Congress passed the National Housing Act of 1934 to further promote homeownership by providing a system of insured loans that protected lenders against default by borrowers. The mortgage insurance program established by the National Housing Act and administered by the Federal Housing Administration (FHA) reimbursed lenders for any loss associated with a foreclosure up to 80 percent of the appraised value of the home. With the risk associated with default on FHA-backed mortgage loans reduced, lenders extended mortgage loan terms to as long as 20 years and LTVs of 80 percent.

In 1938, Federal National Mortgage Association (FNMA) was established as a government corporation to facilitate a secondary market for mortgages issued under FHA program guidelines. FNMA allowed private lenders to make a greater number of FHA loans since loans could be sold in the secondary market and did not have to be held for the duration of the loan term. New loans could be generated each time the lender sold large bundles of loans to investors in the secondary market. The FNMA also purchased conventional conforming mortgages from lenders. Conventional conforming loans, unlike FHA mortgages, were neither guaranteed nor insured by the federal government. In 1968, FNMA was reconstituted as Fannie Mae and became a publicly traded government sponsored enterprise (GSE). This move allowed the financial activity of Fannie Mae to be excluded from the U.S. federal budget and transferred its portfolio of government insured FHA mortgages to a wholly owned government corporation, Government National Mortgage Association (Ginnie Mae). Fannie Mae's portfolio of conforming loans remained on its balance sheet.

In 1970, the Federal Home Loan Mortgage Corporation (Freddie Mac) was chartered as a GSE and operated in a manner similar to Fannie Mae (although its shares were not traded until 1989). Freddie Mac pooled conforming loans and created mortgage-backed securities (MBSs) which were sold as shares of the pooled loans to investors. The interest yield for these agency securities was between AAA corporate and U.S. treasury obligations, reflecting the low risk of the securities. The development of MBS vastly expanded the secondary market for mortgage loans since investors could purchase shares of a loan portfolio rather than purchase an entire portfolio of intact loans.

The value of Freddie Mac and Fannie Mae to the capital market was related to the implicit U.S. government guarantee of their debt and MBS obligations. Their federal charter required them to support the secondary market for residential mortgages, to assist mortgage funding for low-and moderate-income families, and to consider the geographic distribution of mortgage funding, including mortgage finance for underserved geographic sectors. An ancillary benefit of the MBS product required national standardization of underwriting procedures: appraisals, borrower credit histories, and guidelines for determining borrowers' financial capacity to meet debt obligations. This provided the foundation for real growth in the mortgage market. The mortgage market in the United States was also bolstered by the VA loan program, which provided zero down payment and low interest rates to veterans.

MortgageLo anO riginators

Prior to 1980, the vast majority of residential home mortgage loans were made by savings and loans institutions (S&Ls). These institutions originated, serviced (collected payments and managed escrow accounts for insurance and property taxes), and retained the loans in their own portfolios. S&Ls used the interest earned from their portfolios of 30-year fixed rate home mortgages to pay interest to savings account holders—the yield spread between interest earned on mortgages and interest paid on savings allowed S&Ls to earn consistent profits for decades. The business model used by S&Ls collapsed when the Federal Reserve began to raise short-term rates in the late 1970s to combat inflation pressures, with interest paid on savings accounts now being greater than interest earned on the low-rate mortgages originated in the 1960s and early 1970s. The inverted yield curve led to the failure of S&Ls across the United States and an ensuing government bailout under the auspices of the Resolution Trust Corporation (RTC).

The S&L crisis also led to the unbundling of the mortgage business. Mortgage originations and loan servicing became separate functions, which pushed most new mortgage originations into the secondary market as MBSs or collateralized debt obligations (CDOs). The ability for mortgage originators to sell newly recorded mortgages as MBSs and keep balance sheets uncluttered with large loan portfolios allowed the number of mortgage originators to increase from 7,000 in 1987 to nearly 53,000 in 2006. The largest mortgage loan originators and their relative shares in 2007 are presented in Exhibit 1.

Exhibit 1

Originations and Market Shares for the Largest U.S. Mortgage Loan Originators, 2007 (dollar amounts in billions)

RANK	ORIGINATOR	2007 ORIGINATIONS (IN BILLIONS)	MARKET SHARE
1	Countrywide	$408	15.5%
2	CitiMortgage	272	10.3
3	Wells Fargo Mortgage	210	7.9
4	Chase Mortgage	198	7.5
5	Bank of America	190	7.2
	Others	1,278	48.6
	Total	**$2,628**	**100.0%**

Source: As estimated by Countrywide Financial Corporation in its 2007 10-K.

Expanding Home Ownership and the American Dream

Beginning in the 1970s, social activist groups began to point to statistics that indicated lenders and the FHA were engaged in systematic racial discrimination against minority consumers living in low-income neighborhoods (a practice called "redlining"). Such activists mobilized the U.S. Congress and the Carter Administration to enact the Community Reinvestment Act (CRA) and the Home Mortgage Disclosure Act (HMDA) to remedy social injustices in housing and lending. In part, these acts required financial institutions to provide greater support to low-income areas and provide more detailed disclosures regarding mortgage terms.

Lenders whose disclosures uncovered redlining of low-income neighborhoods defended their practices by pointing to the added risk associated with making loans to those with lower incomes, unstable employment histories, high debt to income levels, or inadequate funds for down payments. The Depository Institution Deregulation and Monetary Control Act of 1980 addressed such concerns by eliminating interest rate caps and allowing lenders to charge higher or subprime rates to higher risk borrowers. The Housing and Community Development Act of 1981 created targets for lenders serving low-income borrowers and allowed FHA borrowers with imperfect credit records to obtain mortgage loans with LTVs of 90 to 95 percent. In 1995 the Clinton Administration expanded high LTV subprime loans under the CRA to further expand homeownership for Americans who were unable to qualify for mortgage loans using conventional underwriting criteria.

TheR esidential Mortgage Market in the United States in the 2000s

The effects of the 60 years of federal legislation promoting homeownership allowed nearly 70 percent of Americans to own a home by 2004. The value of new loan originations had increased from $733 billion in 1994 to an all-time high of $3.12 trillion in 2005, with large spikes in loan origination values occurring in 2001 and 2003 before declining in 2004. Mortgage originations had declined again in 2006 to $2.98 trillion. Exhibit 2 presents the value of total U.S. mortgage originations and the percentage of prime and subprime mortgage loan originations for 1994–2006. A graph representing the percentage of American families owning their own homes for the years 1944 through 2007 is presented in Exhibit 3.

TheS ubprimeM ortgage Market

A subprime mortgage was generally classified as a mortgage loan to a borrower with a low credit score, with a small down payment, or a high debt-to-income ratio. In 1994 the subprime market in the United States was approximately $40 billion and represented approximately 6 percent of total mortgage loans originated. The market for subprime mortgages grew rapidly and by year-end 2005 reached 37.6 percent of total mortgage originations.

At the core of the growth of the subprime market were relaxed underwriting standards. As the appetite for MBSs on Wall Street rose, mortgage brokers widened their sales net to include relaxed documentation requirements and impaired or limited credit histories. Many loans were provided as "stated income loans," whereby the borrower did not have to prove income (such loans became known among mortgage underwriters as "liar loans"). The

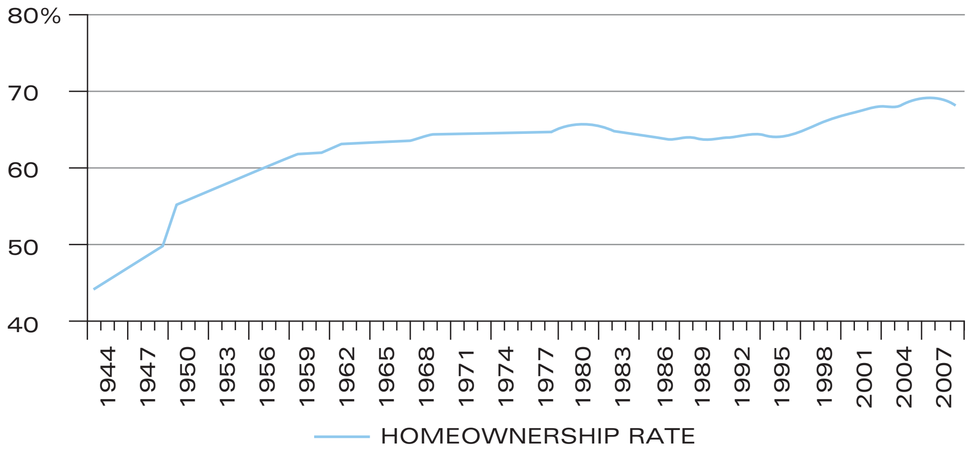
Exhibit2

Value of U.S. Home Mortgage Originations and Percentage of Prime versus Subprime Mortgage Originations, 1994–2006 (dollar amounts in billions)

YEAR	TOTAL US ORIGINATIONS (IN BILLIONS)	PRIME MORTGAGE ORIGINATIONS (PERCENT OF TOTAL)	SUBPRIME MORTGAGE ORIGINATIONS (PERCENT OF TOTAL)
1994	$ 773	94.0%	6.0%
1995	639	86.9	13.1
1996	785	83.2	16.8
1997	859	78.3	21.7
1998	1,450	84.0	15.0
1999	1,310	83.2	16.8
2000	1,048	81.5	18.5
2001	2,215	87.9	12.1
2002	2,885	88.4	11.6
2003	3,945	86.5	13.5
2004	2,920	68.1	31.9
2005	3,120	62.4	37.6
2006	2,980	63.7	36.3

Source: The 2007 Mortgage Market Statistical Annual, *Inside Mortgage Finance*.

EXHIBIT 3 Rate of Home Ownership in the United States, 1944–2007



Source: U.S. Census Data 2007.

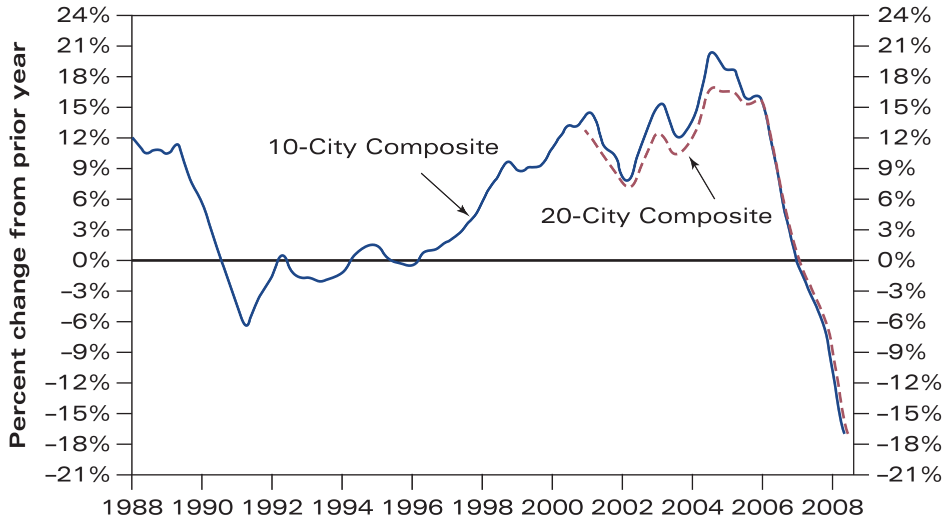
most popular mortgage products with consumers tended to be ARMs, which often included introductory below-market rates. Below-market "teaser" rates allowed for a low monthly payment in the first few years of the loan and then were adjusted in line with market rates thereafter. Some real estate investors and homeowners exploited teaser rates to get into a home and flip the property for a profit before the rate was adjusted. Even if homeowners did not purchase a home with the intention of flipping the house for a profit, the rapid appreciation in home values during the early and mid-2000s allowed overleveraged homeowners to sell their homes and get out of high mortgage payments without great difficulty. However, once the housing market slowed, the excesses of the subprime mortgage market were exposed with resultant increase in delinquencies, defaults, and foreclosures. In fact, in March 2007, the Mortgage Bankers Association reported that 13 percent of subprime borrowers were delinquent on their payments by 60 days or more.

The Housing Bubble of the Mid-2000s

The expansion of homeownership increased demand for both new and existing homes and forced prices upward, creating a housing bubble that began in 1994 and peaked in 2006. In 2006, housing values had increased on average some 16 percent over the previous year. In addition to opportunities to make quick profits from buying and selling houses, rapid appreciation in home prices allowed many homeowners to refinance or take out home equity loans to make improvements to their homes, purchase automobiles, or make other general purchases.

The housing bubble burst in 2007 when the U.S. economy began to weaken, with declining demand for housing causing home prices to plummet. With appreciation in home prices coming to an end, many consumers found their properties underwater (a negative equity position caused by the mortgage balance being greater than the fair market value of the property). Such homeowners who had lost jobs or income during the recession or who had seen their payments on adjustable-rate mortgages rise were faced with foreclosure since they had no hope of selling their home at a price great enough to pay off their mortgage balance. It was estimated that 10 percent to 14 percent of all single-family homes in the United States in 2007, regardless of when they were purchased, had negative equity, making one in seven single-family homes in the

EXHIBIT 4 S&P/Case-Shiller Home Price Indices for Major U.S Cities, January 1988–May 2008



Source: Standard & Poor's and Fiserv.

U.S. underwater.[2] Exhibit 4 presents a graph of percentage increases and decreases in home prices as measured across major U.S. cities for January 1988 through May 2008.

The U.S. Financial Crisis of 2008

With record numbers of mortgages in default, a general liquidity crisis began to unfold which led to an overall loss of confidence in the U.S. financial system. The system unraveled in 2008 when losses at Fannie Mae and Freddie Mac began to mount and American Insurance Group (AIG) announced it was unable to back the insurance guarantees that had supported the Aaa to B bond ratings assigned to MBSs. Wall Street firms had been packaging loans for sale to investors across the world and now found themselves holding securities with little value. As financial institutions were forced to mark their assets to market value, many, including Bear Stearns, Lehman Brothers, Merrill Lynch, Washington Mutual, and Wachovia, were either forced to declare bankruptcy or be acquired by stronger institutions. In September 2008, the United States Treasury provided a bailout to AIG[3] and placed Freddie Mac and Fannie Mae into conservatorships.

Countrywide Financial Corporation

Countrywide Financial Corporation (CFC) was founded in 1969 and on July 2, 2008, was sold to Bank of America for $4 billion in an all-stock transaction. Countrywide's market value in late 2006 was $24 billion, but mounting mortgage defaults and rumors of impending bankruptcy had slashed the company's market value by the time it negotiated its buyout by BoA in January 2008. Angelo Mozilo, the founder and chairman of Countrywide Financial, retired and received a substantial severance package reported at $80 million to $115 million. In June 2009 the Securities and Exchange (SEC) indicted Mozilo for fraudulent misrepresentation of credit and market risk inherent in the Countrywide mortgage portfolio. Exhibit 5 provides key milestones and events in Countrywide Financial's corporateh istory.

Countrywide'sB usiness Segments

Countrywide was a diversified financial service provider engaged in mortgage lending and other real estate finance–related businesses. At its apex in 2006, Countrywide had $2.6 billion

Exhibit5

Key Milestones and Events in Countrywide Financial Corporation's History

1969	Angelo Mozilo and David Loeb launch Countrywide Credit Industries in New York with the aim to one day provide home loans nationwide. Countrywide goes public in September, trading at less than $1 per share. Mozilo and Loeb relocate Countrywide to Los Angeles.
1974	Countrywide opens first retail office in Whittier, Califiornia.
1980	Countrywide has 40 retail offices across eight states.
1981	Mozilo and Loeb launch subsidiary Countrywide Securities Corp. to sell mortgage-backed securities.
1985	Countrywide's ticker symbol, CCR, opens on the New York Stock Exchange on October 7. Stock closes at $2 a share.
1984	The value of loans serviced by Countrywide hits $1 billion. The company begins using computers to originate home loans.
1986	Loan production tops $1 billion.
1987	Loan production soars to $3.1 billion. Countrywide begins servicing loans originated by mortgage lenders.
1993	Countrywide's mortgage-lending reach grows amid a housing and mortgage refinancing boom. Originations increase by 265 percent from 1992.
1996	Company launches business units focused on home equity loans (HELOC) and home loans to borrowers with weak credit histories (subprime).
1998	Mozilo named chief executive in February.
1999	Mozilo named chairman in March.
2000–2005	Countrywide benefits from another housing and refinancing boom coupled with historically low interest rates.
2001	Countrywide acquires Treasury Bank N.A. It goes on to become Countrywide Bank FSB.
2002	Company becomes Countrywide Financial Corp. on November 13, with new stock ticker: CFC.
2006	CFC reports fourth-quarter earnings soar 73 percent to $638.9 million on January 31, as profits climb 29 percent to $2.59 billion.
2007–Jan. 31	CFCs fourth-quarter profits fall 2.7 percent and revenue slips 6 percent. The lender blames falling home prices and fewer home sales for a drop in new mortgage loans.
2007–April 26	CFC first-quarter profits tumble 37 percent; revenue shrinks by 15 percent. Mounting mortgage defaults force CFC to increase loan reserve $81 million and take a $119 million write-down for declining value of some loans on its books. Mozilo blames deteriorating credit in the subprime mortgage market.
2007–July 24	CFC second-quarter profit declines by nearly a third and revenue dips 15 percent.
2007–Aug. 16	A worsening credit crisis sparked by the collapse of the subprime mortgage market and ongoing housing woes force CFC to draw down $11.5 billion from its credit lines.
2007–Aug. 22	CFC raises $2 billion by selling a 16 percent stake to Bank of America.
2007–Sept. 9	Under pressure to reduce costs, CFC reports it will cut as many as 12,000 jobs. Management takes steps to shift lending activity through its banking arm and stop selling subprime loans.
2007–Sept. 18	Speaking at an investor conference, Mozilo declares the company will "come out stronger in the long run, just as we have often done in the past."
2007–Oct. 23	Countrywide outlines stepped-up efforts to help borrowers in trouble avoid foreclosures.
2007–Oct. 26	Countrywide reports a third-quarter $1.2 billion loss, the first quarterly loss for the company in 25 years. Still, Mozilo says he's "bullish" about the long-term prospects of the company and says it expects to be profitable in the fourth quarter and in 2008.
2007–Nov. 20	Rumors surface that CFC may seek bankruptcy protection. CFC issues statement declaring it has ample capital, access to cash and is well positioned to benefit from the financial turmoil rocking the mortgage sector.
2008–Jan. 11	BofA announces acquisition of CFC, subject to shareholder and government approvals, for $4 billion in an all stock transaction.
July 2, 2008	Countrywide officially became a wholly owned subsidiary of Bank of America.

Source: Countrywide Financial Corporation SEC Filings. Annual Reports and press releases.

in net earnings and $200 billion in total assets. The business was managed through five business segments: mortgage banking, banking, capital markets, insurance, and global operations.

- **Mortgage banking.** The origination, purchase, sale, and servicing of noncommercial mortgage loans nationwide.
- **Banking.** Gathered retail deposits used to invest in mortgage loans and home equity lines of credit, sourced primarily through the mortgage banking operation as well as through purchases from nonaffiliates.
- **Capital markets.** The institutional broker-dealer business which specialized in trading and underwriting mortgage-backed securities. The business unit also traded derivative products and U.S. Treasury securities, provided asset management services, and originated loans secured by commercial real estate. Within this segment CFC managed the acquisition and disposition of mortgage loans on behalf of the Mortgage BankingS egment.
- **Insurance.** The property, casualty, life, and disability insurance underwriting provider. The business unit also included reinsurance coverage to primary mortgage insurers.
- **Global operations.** Licensed proprietary technology to mortgage lenders in the United Kingdom and handled some of the company's administrative and loan servicing functions through operations in India.

Mortgage banking was Countrywide's core business, generating 48 percent of its 2006 pretax earnings. A summary of CFC's mortgage loan production for 2003 through 2007 is presented in Exhibit 6.

Countrywide Loan Originations and Market Share

CFC held the largest market share among U.S. mortgage originators in 2007 with 15.5 percent of all originations, up considerably from 2001 when CFC held a 6.6 percent share. As shown Exhibit 7, CFC originated 35,000 loans in 1990, which were more or less evenly split between conventional and VHA/VA loans. It was not until the 1995–1996 period that CFC began to underwrite home equity and subprime loans. The company's loan originations peaked in 2003 with over 2.5 million loans being originated. In 2005, approximately 11 percent of Countrywide's loan originations were subprime and CFC home equity line of credit loans (HELOCs) reached a peak in 2006. Many of Countrywide's HELOCs were part of so-called 80/20 purchase loans that provided borrowers with 100 percent financing. Countrywide's no-down-payment loans allowed borrowers to piggyback a 20 percent LTV home equity line of credit loan on top of a conventional nonconforming 80 percent LTV mortgage. CFC's originations of conventional nonconforming loans began in 2002 and closely matched the company's origination of HELOCs. A significant portion of Countrywide's mortgage loan originations were sold into the secondary mortgage markets as MBSs.

Countrywide'sF inancialan d Strategic Performance

Between 2002 and 2007, Countrywide's assets grew from $58 million to $211 million, and its revenues rose from $4.3 billion to $11.4 billion. The mortgage firm's operating earnings grew from $1.3 million in 2002 to $4.3 million in 2006. After recording record breaking financial results for five consecutive years, CFC reported its first-ever loss in 2007. The dramatic reversal in CFC's financial performance was largely a result of its strategy keyed to the origination of subprime mortgages and no-down-payment loans. The hidden risk of default, foreclosures, and downgrades of such high-risk loans was masked while real estate values rose through 2006. Exhibit 8 presents selected financial data for Countrywide Financial Corporation for 2003 through 2007.

Exhibit6

Countrywide Financial Corporation's Loan Production by Segment and Product, 2003–2007 (in millions)

MORTGAGE LOAN PRODUCTION

	YEARS ENDED DECEMBER 31,				
	2007	2006	2005	2004	2003
Segment:					
Mortgage Banking	$ 385,141	$ 421,084	$ 427,916	$ 317,811	$ 398,310
Banking Operations	18,090	23,759	46,432	27,116	14,354
Capital Markets—conduit acquisitions from nonaffiliates	5,003	17,658	21,028	18,079	22,200
Total Residential Mortgage Loans	408,234	462,501	495,376	363,006	434,864
Commercial Real Estate	7,400	5,671	3,925	358	—
Total mortgage loans	$ 415,634	$ 468,172	$ 499,301	$ 363,364	$ 434,864
Product:					
Prime Mortgage	$ 356,842	$ 374,029	$ 405,889	$ 292,672	$ 396,934
Prime Home Equity	34,399	47,876	44,850	30,893	18,103
Nonprime Mortgage*	16,993	40,596	44,637	39,441	19,827
Commercial Real Estate	7,400	5,671	3,925	358	—
Total mortgage loans	$ 415,634	$ 468,172	$ 499,301	$ 363,364	$ 434,864

* Countrywide Financial did not use the term "subprime." The term "nonprime" was used to categorize subprime mortgages in the company's financial filings.

Source: Countrywide Financial Corporation 2007 10-K.

IncentiveC ompensation at Countrywide Financial

Compensation expense represented approximately 55–60 percent of total expenses between 2003 and 2007. Compensation included employees' base salary, benefits expense, payroll taxes, and incentive pay. Countrywide's compensation system based incentive pay on loan originations and did not include loan defaults as a performance compensation metric. Many lending institutions frowned upon incentive plans linked only to loan originations since loan performance ultimately determined the strength of a loan portfolio. Exhibit 9 provides a graph of incentive pay as a percentage of base pay for all CFC employees during 1992 through 2007.

ExecutiveC ompensationat Countrywide Financial Corporation

The compensation for Mozilo for 2006 and 2007 is shown in Exhibit 10. Mozilo's compensation listed in the table does not include perquisites that amounted to approximately $108,000 per year and included company cars, country club memberships, the personal use of corporate aircraft, insurance, and a financial planning program. Mozilo also exercised $121 million of stock options in 2007 and reportedly stood to collect a reported windfall of $80 million to $115 million on the $4 billion sale of the company to BofA, as part of his severance package. However, after facing heavy criticism from lawmakers, Mozilo said he would forfeit $37.5 million tied to the deal.

Exhibit7

Countrywide Financial Corporation Loan Originations, 1990–2007 (in thousands)

YEAR	CONVENTIONAL CONFORMING	CONVENTIONAL NONCONFORMING	FHA/VA	HELOC	SUBPRIME	TOTAL LOAN ORIGINATIONS
1990	19		16			35
1991	23		17			40
1992	64		24			88
1993	192		42			234
1994	316		67			383
1995	176		72	2		250
1996	192		125	8	2	327
1997	190		144	20	9	363
1998	232		162	41	16	451
1999	529		191	54	25	799
2000	359		132	91	43	625
2001	327		119	119	52	617
2002	994	266	157	290	44	1751
2003	1510	493	196	292	95	2586
2004	822	430	102	392	219	1965
2005	767	712	80	493	254	2306
2006	709	649	90	581	227	2256
2007	1088	313	138	330	85	1954

Source: Countrywide Financial Corporation 10-Ks, various years.

Exhibit8

Selected Consolidated Financial Data for Countrywide Financial Corporation, 2003–2007 (in thousands, except per share data)

	YEARS ENDED DECEMBER 31,				
	2007	2006	2005	2004	2003
Statement of Operations Data:					
Revenues:					
Gain on sale of loans and securities	$2,434,723	$5,681,847	$4,861,780	$4,842,082	$5,887,436
Net interest income after provision for loan losses	587,882	2,688,514	2,237,935	1,965,541	1,359,390
Net loan servicing fees and other income (loss) from MSRs and retained interests	909,749	1,300,655	1,493,167	465,650	(463,050)
Net insurance premiums earned	1,523,534	1,171,433	953,647	782,685	732,816
Other	605,549	574,679	470,179	510,669	462,050
Total revenues	6,061,437	11,417,128	10,016,708	8,566,627	7,978,642
Expenses:					
Compensation	4,165,023	4,373,985	3,615,483	3,137,045	2,590,936
Occupancy and other office	1,126,226	1,030,164	879,680	643,378	525,192

Exhibit 8 (continued)

	2007	2006	2005	2004	2003
Insurance claims	525,045	449,138	441,584	390,203	360,046
Advertising and promotion	321,766	260,652	229,183	171,585	103,902
Other	1,233,651	969,054	703,012	628,543	552,794
Total expenses	7,371,711	7,082,993	5,868,942	4,970,754	4,132,870
(Loss) earnings before income taxes	(1,310,274)	4,334,135	4,147,766	3,595,873	3,845,772
(Benefit) provision for income taxes	(606,736)	1,659,289	1,619,676	1,398,299	1,472,822
Net (loss) earnings	$ (703,538)	$2,674,846	$2,528,090	$2,197,574	$2,372,950
Per Share Data:					
(Loss) earnings					
Basic	$(2.03)	$4.42	$4.28	$3.90	$4.44
Diluted	$(2.03)	$4.30	$4.11	$3.63	$4.18
Cash dividends declared	$0.60	$0.60	$0.59	$0.37	$0.15
Stock price at end of period	$8.94	$42.45	$34.19	$37.01	$25.28
Selected Financial Ratios:					
Return on average assets	(0.30%)	1.28%	1.46%	1.80%	2.65%
Return on average equity	(4.57%)	18.81%	22.67%	23.53%	34.25%
Dividend payout ratio	N/M	13.49%	13.81%	9.53%	3.39%
Selected Operating Data (in millions):					
Loan servicing portfolio(1)	$1,476,203	$1,298,394	$1,111,090	$838,322	$644,855
Volume of loans originated	$415,634	$468,172	$499,301	$363,364	$434,864
Volume of Mortgage Banking loans sold	$375,937	$403,035	$411,848	$326,313	$374,245

(1) Includes warehoused loans and loans under subservicing agreements.

	DECEMBER 31,				
	2007	2006	2005	2004	2003
Selected Balance Sheet Data at End of Period:					
Loans:					
Held for sale	$ 11,681,274	$ 31,272,630	$ 36,808,185	$37,347,326	$24,103,625
Held for investment	98,000,713	78,019,994	69,865,447	39,661,191	26,375,958
	109,681,987	109,292,624	106,673,632	77,008,517	50,479,583
Securities purchased under agreements to resell, securities borrowed and federal funds sold	9,640,879	27,269,897	23,317,361	13,456,448	10,448,102
Investments in other financial instruments	28,173,281	12,769,451	11,260,725	9,834,214	12,647,213
Mortgage servicing rights, at fair value	18,958,180	16,172,064	—	—	—

continued

Exhibit 8 (continued)

	2007	2006	2005	2004	2003
Mortgage servicing rights, net	—	—	12,610,839	8,729,929	6,863,625
Other assets	45,275,734	34,442,194	21,222,813	19,466,597	17,539,150
Total assets	$211,730,061	$199,946,230	$175,085,370	$128,495,705	$97,977,673
Deposit liabilities	$60,200,599	$55,578,682	$39,438,916	$20,013,208	$9,327,671
Securities sold under agreements to repurchase	18,218,162	42,113,501	34,153,205	20,465,123	32,013,412
Notes payable	97,227,413	71,487,584	76,187,886	66,613,671	39,948,461
Other liabilities	21,428,016	16,448,617	12,489,503	11,093,627	8,603,413
Shareholders' equity	14,655,871	14,317,846	12,815,860	10,310,076	8,084,716
Total liabilities and shareholders' equity	$211,730,061	$199,946,230	$175,085,370	$128,495,705	$97,977,673

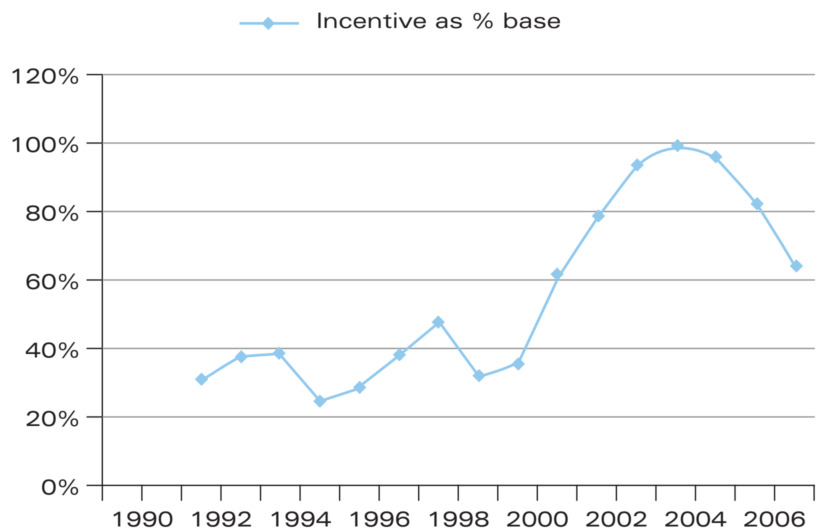
The 2007 capital ratios reflect the conversion of Countrywide Bank's charter from a national bank to a federal savings bank. Accordingly, the ratios for 2007 are for Countrywide Bank calculated using OTS guidelines and the ratios for the prior periods are calculated for Countrywide Financial Corporation in compliance with the guidelines of the Board of Governors of the Federal Reserve Bank.

Source: Countrywide Financial Corporation 2007 10-K.

Charges of Predatory Lending Practices at Countrywide

Predatory loans were generally considered to be any loan that a borrower would have rejected with full knowledge and understanding of the terms of the loan and the terms of alternatives available to them. Predatory lenders typically relied on a range of practices including deception, fraud, and manipulation to convince borrowers to agree to loan terms that were unethical or illegal. Countrywide Financial was charged with engaging in predatory lending practices in the case *Department of Legal Affairs (Florida) v.*

EXHIBIT 9 **Incentive Pay as Percentage of Base Pay for All Employees of Countrywide Financial Corporation, 1992–2007**



Source: Countrywide Financial Corporation 10-Ks, various years.

Exhibit10

Angelo Mozilo's Comensation at Countrywide Financial Corporation, 2006–2007

COMPENSATION COMPONENTS	2006	2007	% CHANGE
Base salary	$ 2,900,000	$ 1,900,000	(34%)
Annual incentive	20,461,473	0	(100%)
Equity awards	19,012,000	10,000,036	(47%)
Total	$ 42,373,473	$ 11,900,036	(72%)
Exercised options	—	$121,502,318	n/a

Note: n/a = not applicable.
Source: Countrywide Financial Corporation 2007 10-K.

Countrywide Financial Corp. et al., filed June 30, 2008). Specific illegal practices alleged in the case included:

1. CFC did not follow its own underwriting standards.
2. CFC did not follow industry underwriting standards.
3. CFC placed borrowers into loans they knew they could not afford.
4. CFC failed to properly disclose loan terms including
   a. Misrepresenting duration of "teaser rates."
   b. Misrepresenting adjustable rates as fixed rates.
   c. Misrepresenting the manner and degree of payment increases after initial fixed rate period.
   d. Not disclosing that low teaser rates would expire and dramatically increase resulting payments that might be far beyond borrower's means.
5. CFC knowingly placed borrowers in inappropriate mortgages.
6. CFC provided underwriters with bonuses based upon volume of mortgages approved.

Countrywide portrayed itself as underwriting mainly prime quality mortgages using rigorous underwriting standards. Concealed from shareholders was the true Countrywide, an increasingly reckless lender assuming greater and greater risk. From 2005 to 2007, Countrywide engaged in an unprecedented expansion of its underwriting guidelines and was writing riskier and riskier loans, according to the SEC. A series of internal e-mails confirmed that senior executives knew that defaults and delinquencies would rise. In particular, the Securities and Exchange Commission (SEC) pointed to Countrywide's increased origination of pay-option mortgages, which allow borrowers to choose their monthly payments even if they did not cover the entire interest amount. While CFC maintained these loans were prudently underwritten, the SEC stated that Mozilo wrote in an e-mail that there was evidence that borrowers were lying on their applications and many would be unable to handle the eventual higherp ayments.

Angelo Mozilo's Internal E-mails at Countrywide Financial Corporation

In June 2009, the SEC filed civil-fraud charges against three former Countrywide executives, including Angelo Mozilo. The complaint cited e-mails sent by Mozilo as evidence of fraudulent behavior at Countrywide Financial. The statements below are from excerpts of Mozilo e-mails released by the SEC.

April 13, 2006: To Sambol (Countrywide Financial Corporation President) and others to address issues relating to 100 percentage financed loans, after Countrywide had to buy back mortgages sold to HSBC because HSBC contended they were defective:

> Loans had been originated . . . throughout channels with disregard for process and compliance with guidelines.

April 17, 2006: To Sambol concerning Countrywide's subprime 100 percent financing 80/20 loans. (The term "FICO" refers to credit scores used to assess borrower's creditworthiness.)

> In all my years in business I have never seen a more toxic product. It's not only subordinated to the first, but the first is subprime. In addition, the FICOs are below 600, below 500 and some below 400. With real estate values coming down . . . the product will become increasingly worse. There has to be major changes in this program, including substantial increases in the minimum FICO. . . . Whether you consider the business milk or not, I am prepared to go without milk irrespective of the consequences to our production.

Sept. 26, 2006: Following a meeting with Sambol the previous day about Pay-Option ARM loan portfolio:

> We have no way, with any reasonable certainty, to assess the real risk of holding these loans on our balance sheet. . . . The bottom line is that we are flying blind on how these loans will perform in a stressed environment of high unemployment, reduced values and slowing home sales . . . timing is right . . . to . . . sell all newly originated pay option and begin rolling off the bank balance sheet, in an orderly manner.

Countrywide's VIP LoanP rogram

Countrywide maintained a VIP program that waived points, lender fees, and company borrowing rules for "FOAs"—Friends of Angelo, a reference to CFC's Chief executive Angelo Mozilo. While the VIP program also serviced friends and contacts of other CFC executives, it is believed the FOAs made up the biggest subset. Some FOAs were individuals who might have been in position to aid the company through regulatory and compliance matters or who may have been able to keep the subprime market viable through favorable legislation. Countrywide's ethics code barred directors, officers, and employees from "improperly influencing the decisions of government employees or contractors by offering or promising to give money, gifts, loans, rewards, favors, or anything else of value." Also, federal employees were prohibited from receiving gifts offered because of their official position, including loans on terms not generally available to the public. Senate rules prohibit members from knowingly receiving gifts worth $100 or more in a calendar year from private entities that, like CFC, employed a registered lobbyist.

Among the most noteworthy recipients of Countrywide VIP loans were two prominent U.S. Senators, two former Cabinet members, and a former Ambassador to the United Nations. In 2003 and 2004, Senators Christopher Dodd, a Democrat from Connecticut and chairman of the Senate Banking Committee,[4] and Kent Conrad, a Democrat from North Dakota, chairman of the Senate Budget Committee and a member of the Senate Finance Committee, refinanced properties through CFC's VIP program.

Other participants in the VIP program included former Secretary of Housing and Urban Development (HUD) Alphonso Jackson, former Secretary of Health and Human Services Donna Shalala, and former U.N. ambassador and Assistant Secretary of State Richard Holbrooke. Jackson was deputy HUD secretary in the Bush administration when he received the loans in 2003. Shalala, who received two loans in 2002, had by then left the Clinton Administration for her current position as president of the University of Miami. Holbrooke, whose stint as U.N. ambassador ended in 2001, was also working in the private sector when he and his family received VIP loans. Mr. Holbrooke was an adviser to Hillary Clinton's presidential 2008 campaign. James Johnson, who had been advising presidential candidate Barack Obama on the selection of a running mate in

2008, resigned from the Obama campaign after *The Wall Street Journal* reported that he received CFC loans at below-market rates.

Bank of America's Attempts to Salvage Its Acquisition of Countrywide Financial Corporation

Almost as soon as the acquisition closed, BofA entered into an \$8.7 billion settlement agreement with a group of state attorneys general over CFC's lending practices. BofA also agreed to modify the loans of certain CFC borrowers with subprime and pay-option mortgages. In the first four months following the settlement agreement, BofA contacted more than 100,000 potentially eligible borrowers, twice the requirement in the agreement, and completed modifications for more than 50,000 of them. The settlement was the largest predatory lending settlement in U.S. history as of 2009.

In March 2009, American International Insurance Group (AIG) sued BoA over Countrywide's business practices, alleging the company misrepresented the risk associated with the sale of mortgages totaling over \$1 billion. AIG claimed that CFC had falsely represented that its mortgages were in compliance with its AIG underwriting standards.

BofA retired the Countrywide brand name in 2009 as it worked to distance itself from the brand and CFC's business practices. According to California Attorney General Edmund Brown, "CFC lending practices turned the American dream into a nightmare for tens of thousands of families by putting them into loans they could not understand or ultimately could not afford."[5] Going forward, Bank of America senior managers would need to develop a strategic approach to ensure that its mortgage lending practices promoted homeownership in a manner that was in the best interest of borrowers, investors in the secondary mortgage market, and the company's own long-term financial interests.

Endnotes

[1] These products were developed following the Savings and Loan (S&L) crisis of the 1980s and converted the actual mortgage into pools of mortgages, which enabled institutions to invest and trade a marketable security. MBSs were also known as collateralized debt obligations.

[2]Moody' s Economy.com.

[3] AIG's core business as the world's largest general insurer was sound. However, AIG's CDO insurance business, while a very small part of their overall business, has brought the firm close to bankruptcy. As for AIG's global reach, it was far too extensive and a default would have brought down other financial institutions across the world markets.

[4] CFC had contributed a total of \$21,000 to Dodd's campaigns since 1997.

[5] As quoted in Frank D. Russo, "Attorney General Brown Announces Largest Predatory Lending Settlement in History," *California Progress Report,* accessed at http://www.californiaprogressreport.com/2008/10/attorney_genera_3.html (accessed September 5, 2009).

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